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UNITED STATES ACCESS TO JAPANESE FINANCIAL MARKETS

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

MAY 6, 1987

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WEDNESDAY, MAY 6, 1987

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee convened, pursuant to notice, at 9:05 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Lawton Chiles (chairman of the committee) presiding.

Present: Senators Chiles, Domenici and Grassley.

Staff present: Richard N. Brandon, staff director; and John Hilley, assistant director for macro-economics, trade and finance.

For the minority: G. William Hoagland, staff director; and Gail Fosler, deputy staff director and chief economist.

OPENING STATEMENT OF CHAIRMAN CHILES

Chairman CHILES. Good morning. Today, the Senate Budget Committee will examine the level of access that American financial firms have to Japanese financial markets.

With us today is Gerry Corrigan, the president of the Federal Reserve Bank of New York, and Mr. Robert Binney of the Chase Manhattan Bank in Tokyo. We certainly welcome both of you gentlemen, and thank you for joining us.

Every time we gather in this room, the deficit is always with us. We have talked about high real interest rates, the value of the dollar, the huge build-up of debt, and borrowing, and each of these questions, and a great many others, all bring us back to the same topic of the deficit.

The deficit has made us borrow money, and money we have borrowed from abroad has altered the financial balance of power in the world. For decades we were the leading creditor in the world. Now we have changed places to become the world's greatest debtor while Japan lends much of the money.

We owe roughly $200 billion, and Japan holds claim to about that same amount against the rest of the world.

JAPANESE FINANCIAL INSTITUTIONS LARGEST IN WORLD

The Japanese financial institutions are now the largest and the strongest in the world, and measured by a market capitalizations, 9 of the world's 10 largest banks are Japanese.

Major security firms in Japan are giants compared to ours, and Japanese financial institutions are now top players in our markets.

Japanese banks underwrote half the municipal bonds issued in the United States last year.

When you consider that five of the largest banks in California are controlled by Japan, and the prospect for branching out into other States is strong, it is clear that Japanese financial enterprise has made great headway in this country.

They have been ambitious and successful. Last year alone, the Industrial Bank of Japan, working through Schroder Bank & Trust, bought Aubrey Lanston, a primary dealer in Government securities.

Two of Japan's "big four" securities dealers were granted primary legal status by the Federal Reserve Bank of New York, and Sumitomo Bank has made a half billion dollar investment in Goldman Sachs.

The Japanese are very smart at watching and influencing what we are doing. They have more lobbyists and agents in America than in any other country.

The listing of Japanese agents in America takes up 50 pages in the Attorney General's report on foreign registration.

AMERICAN FIRMS MAKING PROGRESS IN JAPANESE MARKETS

They are organized and determined players in our markets. How are American financial concerns doing in the Japanese markets?

The "National Treatment Update" issued by the Department of Treasury shows some progress. For example, four American firms have been allowed to buy seats on the Tokyo stock exchange. There has been some interest rates deregulation, and the restrictions on foreign exchange trading have been relaxed to some extent.

I think more can be done and more should be done to open up access to Japanese financial markets. In our own country, we have not denied access to our allies who wish to participate in our financial markets.

This morning I hope you will go over with us the current level of access that we have to Japanese financial markets. I would like to know where improvements have been made, hear where improvements should be made, and get any recommendations you have about how we might proceed.

In the past several years, we have all heard other countries tell us about the so-called "new realism." That is supposed to mean that the United States cannot expect to dominate the financial markets anymore.

I think the new realism should work both ways. If there are not supposed to be any dominant players, then all players should have the same right to participate.

The committee is certainly looking forward to your views this morning. Mr. Corrigan, we will start with you, and we thank you very much for your appearance here today.

STATEMENT OF E. GERALD CORRIGAN, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. CORRIGAN. Thank you very much, Mr. Chairman, and I would like to ask if my entire statement could be admitted for the record.

Chairman CHILES. Your statement in full will be put in the record.[1]

Mr. CORRIGAN. But I would, as a matter of emphasis, like to just focus on several aspects of it by way of introduction.

I should also say that I thought the phrase you just used, "new realism," was very apt to this whole subject. And as part of that realism, I think, as you also recognize, that we have to recognize that Japan's rather unique position in the financial sphere did not develop in a vacuum.

There are a number of underlying points of reference that I think we have to keep in mind as we seek to relieve some of the points of stress and tension that are so evident in current circumstances.

MACROECONOMIC CONSIDERATIONS RESPONSIBLE FOR SEVERE IMBALANCES

The first of those is that Japan's external surplus over the decade of the 1980's grows fundamentally out of a series of macroeconomic considerations including: first a persistent and very large savings gap in the United States coupled with Japan's extraordinarily high savings rate; and second, the more rapid growth in our domestic economy vis-a-vis others during the early stages of the current expansion.

There is also the related issue of apparent differences in the ability of U.S. firms, perhaps especially manufacturing firms, to compete effectively in the external marketplace, or with external competitors here.

All three of those factors, together with associated swings in exchange rates—swings, I might add, that in my view tend to be exaggerated by the marketplace—lie at the heart of the severe imbalances we see in the world economy.

The relative openness, or lack thereof, of Japanese financial markets are, at most, a marginal factor insofar as those underlying causes of the trade and current account imbalances are concerned.

Second, as I think the committee knows very well, the adjustment process is going to take time and effort, but it must fundamentally deal with the underlying factors that are at issue here.

And again, financial access, while important, is not decisive.

CAPITAL INFLOWS NECESSARY FOR SEVERAL YEARS

The third point you have just touched on yourself, Mr. Chairman, and that is, that under the best of circumstances, the United States will be dependent upon capital inflows from abroad for several years to come.

That is, and I want to stress to you, using a purely hypothetical example, even if our own budget and trade deficits would begin to wind down—and there are signs that both are—at roughly the same rates that they increased, the overall adjustment process will take several years at best, and over that entire period we will continue to have relatively large current account deficits which will cumulate.

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[1] See p. 11.

That of course implies that our external indebtedness, which you just touched upon, will continue to grow, even at a slower rate, and indeed, it seems to me that by the end of the decade, the $200 billion number that you mentioned could easily be a half a trillion dollars.

The key point in that context is that to the extent those necessary capital inflows are impeded, for whatever reason, the implications for interest rates and exchange rates, and therefore, for domestic economic activity, are almost certainly going to be detrimental here, and elsewhere.

To put it very directly, we must take care to conduct our affairs in such a way that our foreign creditors will be willing to acquire, and to hold, the needed amounts of dollar-denominated assets, at interest rates and exchange rates that are otherwise consistent with noninflationary growth in the United States and in the world economy.

GLOBALIZATION OF FINANCIAL MARKETS A REALITY

The last point that I think needs to be stressed is also one you touched on, Mr. Chairman, and that is, whether we like it or not, the globalization of financial markets and institutions is a reality.

And since that reality has been brought about fundamentally by technology and innovation, it cannot be reversed in any material way by regulation or legislation.

And while this process of globalization and innovation is producing important benefits to suppliers and users of financial services, it also produces anomalous results. To cite just two quick examples: Japanese securities companies, whether they are owned by Japanese firms, or foreign firms, cannot generally engage in foreign exchange trading and position-taking in Tokyo, but they do it in London or New York.

By the same token, U.S. banking companies cannot generally underwrite corporate debt and equity securities in the United States, so they turn around and do it in London, or Sydney, or elsewhere.

That is symptomatic of a larger problem, and that larger problem is that our national systems of supervision and regulation, to say nothing of tax and accounting policies that were created many years ago, simply were not designed for a marketplace of worldwide dimensions in which firms with differing charters and national origins, compete head to head with each other around the clock and around the world.

This is one of the reasons why I firmly believe that our own Congress must get on with the task of fundamental reform in the structure of our banking and financial system, a task that is already well underway in several countries.

Those are the fundamentals as I see it, and in seeking constructive solutions to some of the particular points of tension I will get to in a moment, I think we must be sensitive to that larger picture, and we must rcognize that solutions to those larger problems are not to be found in the generally narrow context of specific equity and access issues pertaining to U.S. financial firms' activities abroad, as important as those issues are for other reasons.

FOREIGN PRESENCE IN FINANCIAL MARKET

I have included in my statement, Mr. Chairman, an overview of financial market activities with some particular emphasis on foreign presence, and so on, in Tokyo, London, and New York. I will not go into that in any detail at this point, except to make three brief points.

First, as a general matter, there are differences, of course, from country to country, but, by and large, the differences insofar as treatment based on national origin is concerned, are not fundamentally a matter of law, as important as they are in many, many instances.

The second point, which again you have touched on is, on the banking side, Japanese banking presence in the United States is indeed quite large, something like close to 10 percent of banking assets, 10 percent of commercial and industrial loans and, in selective markets—standbys for commercial paper or municipal financings—the Japanese market share can run anywhere from 25 to almost 50 percent of the entire market.

The U.S. presence in Japan, on the other side, is quite modest for a variety of reasons, but included among those reasons are the particular rigidities associated with the short-term money market, in particular, in Japan.

On the securities side, as a rough approximation, the relative size and importance of U.S. securities firms in Japan, and Japanese securities firms in the United States, are roughly equal, although as I say in the statement, there are clearly points of tension on the table having to do with U.S. securities firms in Japan that are not generally in evidence insofar as Japanese securities firms in the United States are concerned.

MAJOR CHANGES MADE IN JAPANESE FINANCIAL MARKETS

Now moving on to another subject that you asked me to comment on, and that is the recent history of Japanese initiative in the area of deregulation and access. I think there, too, you must recognize that, for starters, the post-war Japanese financial system was in many respects modeled after the U.S. system.

Not surprisingly, therefore, several features of the Japanese system, which are the subject of controversy today, including interest rate ceilings on deposits, and legal barriers separating classes of financial institutions, including commercial and investment banks, are precisely the same issues that have and continue to provoke controversy in the United States.

In Japan, as with the United States, sweeping pressures for change in the structure and regulation of financial markets and institutions were largely mooted until the late 1970's and early 1980's.

In response to those factors, the Japanese authorities, under prodding from the United States and other governments have, over the past several years, made what I consider to be major changes in the structure and regulation of their financial markets, including important reductions to barriers of foreign presence in the Tokyo markets.

I have listed some of those major features in some detail in one of the appendices to my statement. I would simply add that taken as a whole, the actions by the Japanese over the past several years are noteworthy, especially in the relatively short timeframe involved.

I would believe that a case can be made, as a matter of fact, the the Japanese record over the past several years is probably better than some observers suggest, and in my view is good enough to warrant confidence at this time that further progress will be made in the future.

BARRIERS TO U.S. COMPANIES STILL REMAIN

Having said that, I would hasten to add that despite this situation, the situation in Japan is still one in which barriers, visible and invisible, to open and effective competition between United States and Japanese financial firms, remain important factors limiting the activities and competitive effectiveness of U.S. firms in Japan.

It is also true, as again you indicated in your opening remarks, Mr. Chairman, that as the strategic importance of the Tokyo marketplace continues to grow, and competitive pressures mount, concerns about those barriers have received increased attention.

But I would also say, in fairness, that in a number of important instances, specific issues raised by U.S. firms have little, or nothing, to do with national treatment considerations per se.

Now, again, in my statement I have attempted the heroic, and that is to try to classify these points of tension and concern.

I admit that the classification attempt is imperfect, but I have tried to put them into four categories: (1) Equal treatment issues, such as the stock exchange question; (2) regulatory policies, including money market deregulation, and particularly I would want to stress the issue of important differences as they relate to capital adequacy standards for banks, which I will touch on in a moment.

The third category is limitations on acquisition, and a fourth, which in some ways may be the most important category, is the so-called "invisible barriers". By that of course I mean a host of considerations ranging from language and custom to relationships with bureaucrats, which can be barriers to market participants in any foreign center, and Japan is certainly no exception.

Some observers would contend that the so-called "invisible barriers" in Japan are more of a problem than is the case in other financial centers. You also inquired, Mr. Chairman, as to the record of the Japanese in this area in the recent past, and again, in my statement, I have singled out a number of, what I think are important and constructive initiatives that the Japanese have taken just in the last couple of months.

INITIATIVES TAKEN TO ALLOW ACCESS TO SECURITIES MARKETS

I will not go through those in detail, either, except to say that they are in the areas of further steps in deposit regulation, and the licensing, or about-to-be licensing, of securities affiliates of U.S. banks. That is particularly important because that is a situation which is about to provide access to Japanese securities markets for

U.S. banks, even though such access is not available to Japanese banks.

And just as a further anomaly, it would also permit U.S. bank affiliates in Japan a wider range of securities activities than are permissible right here in the United States.

I also spell out in some detail further steps that have been taken by the Japanese to provide more equitable access to new issues of Government securities in the yen markets.

Those particular initiatives are important in that they represent further steps in the direction of opening up that market. Indeed, as late as 1978, that entire market was run through the syndicate. Now, about 35 percent of the overall market is auction driven, but as I say in my statement, in the case of the 10-year bond, which is particularly important in Japan, that is still handled by syndicate.

The Ministry of Finance does indicate that as of April 1, the shares available to foreign securities firms in the overall securities portion of the syndicate will rise from a little over 1 percent to almost 6 percent.

While still small, we understand that those shares, for a foreign group, as a whole are roughly commensurate with the overall size of foreign securities firms' activities in the secondary market.

Taken in the context of the measures initiated by the Japanese authorities over the past several years, and taken in the context of further steps that may be under consideration at present, which I will touch on in a moment, these latest initiatives strike me as helpful and as reflective of continued good-faith efforts to move ahead with financial market liberalization.

To be sure, however, further effort on a variety of fronts is needed. And let me just, now, touch on the areas that strike me again as most important in looking to the future.

CONTINUED PROGRESS EXPECTED IN FOUR AREAS

Indeed, I would hope and expect to see continued progress in four areas. First, greater access to the Japanese government securities market for foreigners.

In this area, I believe that the Japanese authorities may be considering one or more of the following possible steps. First, the offering, through auction, of new maturities in an intermediate- and longer-term area, which would work in the direction of increasing further the percent of its issues sold through auction.

Second, shifting the 20-year issue from syndicate to auction. And third, the use of something like the U.S. noncompetitive tender system in the 10-year maturity, which would provide, or could provide larger shares to U.S. market participants, while still preserving the syndicate framework.

Needless to say, I would welcome initiatives along these lines, which could pave the way to the day in which the auction method of issuing debt was the general practice.

This in turn would be an important step, and as I see it, an extremely useful step from a Japanese point of view, toward moving the general market practices in the Government securities market, their own Government securities, more in line with practices here, and in London.

The second area that I would mention is increased representation on the Tokyo stock exchange. As I understand it, Mr. Chairman, plans are now underway to expand the number of seats on the exchange, including seats held by foreigners, next spring, when new facilities and computer capabilities will be in place.

Procedurally, this will entail the establishment of a membership committee within the exchange in the near term. I am led to believe that the committee's deliberations should be completed and its recommendations made to the full exchange late this year.

Here, too, I would expect that the results of these deliberations would be some added representation of U.S. firms on the exchange.

I would also hope that the time schedule for this process could be accelerated, but I do understand the practical problems involved.

A third area of particular importance is continued liberalization in the money markets themselves. I had indicated earlier in my statement that the next round of discussions between Japanese authorities and the U.S. Treasury is scheduled to take place, shortly, on precisely this subject.

Those discussions will, among other things, focus on what further steps might be taken to reduce rigidities in the Japanese money market, which in turn can make it easier for U.S. institutions to compete in that market, and in that currency, and thereby more easily fund Japanese-based lending and securities market activities in the local market, in the local currency.

EMPHASIS PLACED ON BANK CAPITAL ADEQUACY STANDARDS

Finally, that bank capital standard. The areas I have mentioned a moment ago are important. The single item on which I would place greatest emphasis relates to bank capital adequacy standards, and specifically to the goal of moving Japanese bank capital standards into closer alignment with emerging international standards.

Efforts to establish international standards for bank capital adequacy have been underway in the Bank for International Settlements for about 3 years.

This effort was undertaken by the G–10 Central Bank Governors, in recognition of the fact that both competitive and prudential considerations pointed to the need for such standards as the globalization of banking proceeded apace.

While these efforts are proceeding in the BIS, and through other international organizations, the United States and the United Kingdom reached agreement, earlier this year, on a joint approach to capital standards in our respective countries.

Such proposals were made available for public comment in January, and final rules are expected to be put in place some time later this year.

Senior officials of both the Bank of Japan and the Ministry of Finance have indicated that they agree, in principle, that Japanese bank capital standards should, in due course, be brought into broad alignment with these standards, and preliminary discussions between senior Federal Reserve, Bank of England, and Japanese officials have been held on this subject.

Further discussions are scheduled in the very near term. Achieving the needed degree of convergence in this area, as I said, is of

great importance, both in narrow terms and in broad strategic terms, but it will be much more difficult in the case of Japan than was true at the United Kingdom, because the starting points—in terms of accounting rules, tax rules, et cetera, with Japan, are much further removed from prevailing practice than the United States and the United Kingdom.

Moreover, as we have seen with our own banks, here, in the United States, even relatively minor changes in this area can be very, very controversial.

Thus, while achieving convergence with the Japanese in this area is a long and difficult process, progress along these lines is extremely important.

As I see it, Mr. Chairman, the four areas that I have just mentioned are the clear priorities. Given the progress that has been made in the past, I remain confident that efforts to move ahead in these, and other areas, will prove fruitful and mutually beneficial.

PRIMARY DEALER AMENDMENT OPPOSED

Partly for this reason, I am opposed to legislative efforts along the lines of the so-called primary dealer amendment that was incorporated into the trade bill passed by the House recently, or along the lines proposed more recently by Senators Proxmire and Riegle. As I see it, such legislation could have the effect of stalling, rather than accelerating, discussions and negotiations in the financial area, while possibly producing unintended adverse side effects, both in terms of general attitudes toward market liberalization, and attitudes regarding capital flows to the United States.

It would be one thing to consider a legislative approach in which progress and good-faith discussions were not taking place. However, as I see it, this is not the situation at the moment.

In concluding, Mr. Chairman, let me return briefly to where I started, with the economic fundamentals. If we are to be successful in winding down our external imbalances in an orderly way, we, in the United States, must live up to our responsibilities as well, and, for us, that means learning to live within our means.

To be sure, actions abroad are needed, and needed badly, but as we call on others to open their markets and stimulate their economies, let us not lose sight of our end of the bargain.

Our Federal budgetary affairs, despite the enormous efforts of this committee and others, are still in a state of disarray and must be put in order.

REFORM OF FINANCIAL STRUCTURE MUST BE ADDRESSED

The need for broad-based reform in our own financial structure must be addressed. Pressing questions as to the degree of underlying competitiveness of our industrial sector must be answered, and patterns of savings and investment in our own economy must be brought into line with the longer term needs of rising productivity and rising standards of living.

If we are to come full circle in restoring balanced growth here at home, and around the world, we must also avoid any renewed outburst of inflation which would undermine prospects on all fronts.

But even more important to the subject at hand, more balanced growth in the world economy would also provide a much more constructive environment in which the legitimate issues regarding financial market practices and evolutions can be resolved here, and elsewhere.

Thank you, Mr. Chairman.

Chairman CHILES. Thank you very much.

[The prepared statement of Mr. Corrigan follows:]

STATEMENT BY

E. GERALD CORRIGAN

PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

BEFORE THE

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

MAY 6, 1987

Mr. Chairman and members of the Committee: I am pleased to be able to appear today in order to discuss with the Committee recent and prospective developments regarding the globalization of financial markets and institutions, with particular emphasis on developments in the three major financial centers of the world: New York, London and Tokyo. Within that broad framework, I will devote particular attention to a series of issues pertaining to access of U.S. firms to money and securities markets in Japan.

I. Background

Legend has it that Willie Sutton once said that he robbed banks because that's where the money was. The analogy is poor, but there can be no doubt that much of the current interest in Japanese financial markets stems from that same consideration: that's where the money is! Indeed, reflecting its very large domestic savings rate and its massive current account surplus, Japan has assumed a unique financial position in the world's community of nations. But Japan's financial position relative to the United States or to the rest of the world did not develop in a vacuum. Thus, before turning to the specific questions raised by the Committee, allow me to comment

briefly on the general economic and financial environment within which we must seek to address the points of stress and tension which are so apparent.

That broader perspective should include at least four major points of reference, as follows:

> First, the dramatic rise in Japan's external surplus over the decade of the 1980's and the corresponding increase in the external deficit of the U.S. are primarily the result of macroeconomic considerations including (1) the persistent and very large domestic savings gap in the United States -- growing importantly out of the huge budget deficits-- coupled with Japan's extraordinarily high internal savings rate; and (2) considerably more rapid growth in domestic demand in the U.S. economy, especially during the earlier stages of the current expansion. There is also the related issue of apparent differences in the ability of U.S. firms, perhaps especially manufacturing firms, to compete effectively in the external marketplace or with external competitors. All three of the factors, together with

associated swings in exchange rates -- swings that in my view tend to be exaggerated by the marketplace -- lie at the heart of the severe imbalances in the world economy. The relative openness, or lack thereof, of Japanese financial markets are at most a marginal factor insofar as the underlying causes of trade and current account imbalances are concerned.

Second, reversing the imbalances that have developed over the past five years will not be easy and will take time. Moreover, if that adjustment is to take place in a context of growth rather than in a framework of contraction, we must deal with the fundamentals. More open external markets for U.S. products and services are an important part of the agenda for adjustment, but absent underlying changes in economic policies and performance here in the U. S. as well as elsewhere in the world, more open financial markets simply will not materially help the adjustment process along.

Third, under the best of circumstances, the United States will be dependent on capital inflows from abroad for several years to come. That is, and to use a purely hypothetical example, even if our budget and trade deficits move lower at roughly the same speed as they increased, the U.S. would still have relatively large -- and cumulating -- current account deficits for the next few years. This, of course, implies that our external indebtedness will continue to grow, even if at a slower rate, such that net capital inflows will be needed. To the extent these necessary capital flows are impeded -- for whatever reason -- the implications for interest rates and exchange rates, and therefore domestic economic activity, are almost certain to be detrimental here and elsewhere. To put it more directly, we must take care to conduct our affairs in such a way that our foreign creditors will be willing to acquire and hold the needed amounts of dollar-denominated assets at

interest rates and exchange rates that are otherwise consistent with non-inflationary growth in the U.S. and world economy. Fourth, whether we like it or not, the globalization of financial markets and institutions is a reality. Since that reality has been brought about importantly by technology and innovation, it cannot be reversed in any material way by regulation or legislation. Moreover, while this process of globalization and innovation is producing important benefits to suppliers and users of financial services, it also produces anomalous results. To cite an example or two, Japanese securities companies -- whether owned by Japanese or foreign firms -- cannot generally engage in foreign exchange trading and position-taking in Tokyo but they do it in London and New York; U.S. banking companies cannot underwrite corporate debt and equity securities in the U.S., but they do it in London or elsewhere.

More generally, national systems of supervision and regulation -- to say nothing

of tax and accounting policies -- that were created many years ago were not designed for a marketplace of worldwide dimensions in which firms with differing charters and national origins compete head-to-head with each other around the clock and around the world. This situation is one of the reasons why I believe the Congress must get on with the task of fundamental reform of the structure of our banking and financial system -- a task that is already well underway in several other countries.

A more rational structure at home -- including a structure that works in the direction of strengthening the banking and financial system -- would help encourage a more rational structure internationally. Both now and in the future, this is probably more important to the prospects for U.S. financial firms and U.S. national interests than are the relatively narrow issues of immediate dispute in particular markets.

In short, there are important and legitimate concerns

that must be dealt with pertaining to access of U.S. firms to foreign financial markets. However, in seeking constructive solutions to those problems, we must be sensitive to the larger picture and we must recognize that the solutions to these larger problems are not to be found in the relatively narrow context of specific equity and access issues pertaining to the activities of U.S. financial firms abroad, as important as those issues are for other reasons.

II. Major International Financial Markets: An Overview

At the risk of injuring the sensitivities of our friends in Frankfurt, Zurich or Hong Kong -- to say nothing of Chicago or San Francisco -- it is probably fair to say that there are three dominant financial centers in the world today: London, Tokyo and New York. Accordingly, and to provide some further perspective, Exhibit I attempts to categorize the scope of activities available to various classes of domestic and foreign institutions in each of these markets.

As the exhibit indicates, there are important differences from one market to the other, but as a general matter, these differences do not reflect strictly legal distinctions based on the national origin of the firm in question. To put it differently, all three markets have de jure conditions of broad national treatment insofar as the

general range of banking and financial activities are concerned even though there are important differences between the centers and, as noted later, important de facto distinctions in terms or competitiveness of foreign versus domestic concerns. For example:

-- as mentioned earlier, banks, domestic or foreign, cannot as a general matter underwrite corporate securities in New York or Tokyo but they may do so in London.

-- securities companies, domestic or foreign, may not as a general matter deal in foreign exchange in Tokyo but they may in London and New York.

-- in two instances, there is a small tilt in favor of U.S. banks in that as of March of this year, U.S. banks in Tokyo may have a securities affiliate whereas domestic Japanese banks may not, and U.S. banks were permitted in 1986 to own trust banks in Tokyo whereas Japanese city banks may not. By the same token, there are a number of foreign banks (none of which is Japanese) which have grandfathered securities subsidiaries in the U. S.

In short, looking at broad classes of financial activities in the three major centers does not suggest that

there are systematic patterns of discrimination against foreign participants in any of the centers that are rooted in law. However, the simple "yeses" and "noes" in Exhibit I do not even begin to tell the whole story. Thus, the balance of this section will look at the individual markets in somewhat greater detail.

A. Banking Markets

For several decades, foreign banking institutions have had a major presence in the United States. This reflected several key factors including: (1) the multinational population base of the U.S.; (2) the size and importance of U.S. markets; and, (3) the role of the U.S. dollar as a reserve currency and an international medium of exchange.

Typically, foreign banks operating in the U.S. market concentrate their activities heavily on the so-called wholesale market. While there are some important exceptions, foreign banks are generally not major factors in retail banking markets. In addition, most of the foreign banks that have a sizable presence in the U.S. are affiliated with well-known major banks abroad, many of which have Triple-A credit ratings. Needless to say, the prominent names of some of these institutions, together with their credit ratings, give them important recognition in their activities here in the U.S.

As of year-end 1986, there were more than 250 foreign banks that had some kind of presence in the United States. In the aggregate, the assets of such foreign banks exceeded $500 billion (see Exhibit II) at year-end 1986 and constituted almost 20 percent of total U.S. banking assets. To an extent, this figure is inflated by virtue of the fact that some foreign banks -- notably the Japanese -- book most of their Western Hemisphere loans in U.S. offices. While not shown in the exhibit, foreign banks also account for about 20 percent of all commercial and industrial loans outstanding to U.S. addressees. In both instances, Japanese banks are by far the most dominant group of foreign banks, accounting for nearly half of the total assets and commercial loans outstanding at foreign banks in the U.S. In certain markets, such as standby letters of credit and standby's associated with U.S. municipal bond offerings, Japanese banks now account for between one-quarter and one-half of the total U.S. market.

Measured in terms of numbers of institutions, the U.S. banking presence in Japan is similar to that of Japanese banks in the U.S. However, in terms of asset size, in either absolute or relative terms, U.S. banks are much smaller in Japan than are Japanese banks here with total assets in Japan of something short of $20 billion (see Exhibits III & IV). As in the U.S., most foreign banking activities in Japan are

concentrated in the wholesale markets and in activities such as foreign exchange trading. In the recent past, however, at least one U.S. bank has demonstrated some interest in selective aspects of the Japanese retail banking markets.

The reasons for the relatively small U.S. banking presence reflect a variety of factors. Historical and strategic considerations probably play a role. It is also true that U.S. banks find it more attractive to book Asian loans in Hong Kong or Singapore rather than in Tokyo. Finally, the historical rigidities of the local funding markets in Japan make it difficult to build up a large banking operation in Japan, especially in the face of lingering uncertainties as to the receptivity of Japan to a broad-based presence of major foreign banks.

While the size of the U.S. banking presence in Japan is small, the same cannot be said for London (see Exhibit V). Indeed, the U.S. banking presence in London is more than six times the U. S. presence in Japan. And, U.S. banking assets in the U.K. are roughly three times greater than U.K. banking assets in the U.S. To a considerable extent, the size of U.S. banking operations in London reflects the long history of the importance of the London market, its openness to foreigners, and its association with the Eurocurrency markets which are so important to U.S. companies -- financial and nonfinancial

alike. In short, the London market has, for many years, sought out and welcomed foreign banks in part by maintaining a "friendly" regulatory environment.

B. Securities Markets

The comparative nature and scope of securities markets activities by foreign firms in the three major markets are distorted somewhat because the U.K. does not require strict separation of commercial and investment banking, whereas both Japan and the U.S. make such a distinction. In addition, data on relative size and importance of securities market activities are not as readily available as in banking. However, these limitations notwithstanding, some approximations of size and importance are possible.

In terms of numbers of firms and employment levels, U.S. securities firms' presence in Japan and Japanese securities firms' presence in the U.S. are very roughly equivalent (see Exhibit VI) and both have been growing quite rapidly in recent years. The activities of U.S. securities firms in Japan and Japanese firms in the U.S. also tend to be quite similar in that both are concentrated in trading-type activities. Both classes of institutions are engaged in underwriting activities in each others' markets but, to date, virtually all such underwriting by the foreign participants in

both markets takes place as syndicate members, not as syndicate leaders or managers. In the U.S., four Japanese securities houses (the "big four") are members of the New York Stock Exchange while in Japan three U.S. securities houses -- and one securities company that is owned by a U.S. bank through its London merchant bank -- are members of the Tokyo Stock Exchange.

In short, in many respects, the relative size and importance of U.S. securities firms in Japan and Japanese securities companies in the U.S. are quite similar and, as noted earlier, both are growing rapidly. However, despite these broad similarities, there are particular points of tension regarding the treatment of U.S. financial firms in Japan which are not generally in evidence with regard to the treatment of Japanese financial firms in the U.S.

III. Japanese Initiatives: Financial Deregulation & Access

The post-war Japanese financial system was, in many respects, modeled after the U.S. system. Not surprisingly, therefore, several features of the Japanese system which are the subject of controversy today -- including interest rate ceilings on deposits and legal barriers separating classes of financial institutions including commercial and investment banks -- are precisely the same issues that have and continue to provoke controversy in the United States. In Japan, as with

the United States, pressures for sweeping change in the structure and regulation of financial markets were largely muted until the late 70's and early 80's. Similarly, while U.S. financial firms have, for some time, had a minor presence in Japan, it was not until fairly recently that pressures for greater access built in a major way. These mounting pressures for deregulation and more open access reflected the interaction of a powerful set of macroeconomic forces as well as the wave of change and innovation that is rapidly transforming financial markets and institutions around the world.

In response to these forces, the Japanese authorities -- under prodding from the U.S. and other governments -- have over the past several years made major changes in the structure and regulation of financial markets including important reductions in barriers to foreign presence in the Tokyo markets. A listing of the more important of these initiatives is contained in Appendix III. Taken as a whole, the actions by the Japanese over the past several years are noteworthy, especially in the relatively short time frame involved. Indeed, I believe a case can be made that the Japanese record of the past several years is better than some observers suggest and is good enough to warrant confidence that further progress will be made in the future.

Having said that, I would hasten to add that despite this progress, the situation in Japan is still one in which barriers -- visible and invisible -- to open and effective competition between U.S. and Japanese financial firms remain important factors limiting the activities and competitive effectiveness of U.S. firms in Japan. It is also true that as the strategic importance of the Tokyo marketplace continues to grow and competitive pressures mount, concerns about those barriers have received increasing attention. However, in a number of important instances, specific issues raised by U.S. firms have little or nothing to do with national treatment considerations.

At the risk of a great oversimplification, the points of immediate concern to U.S. firms can be classified as follows:

A. Equal Treatment Issues: While purely legal barriers to national treatment of U.S. firms in Japanese markets have been eliminated, certain distinctions between the treatment of U.S. and Japanese firms are seen as having important competitive implications even though the basis for the distinction is not to be found in law. Concerns about practices for issuing government debt and limitations on seats on the Tokyo Stock Exchange would fit in this category.

B. Regulatory Policies: There are several areas of regulatory policy which are viewed by some U.S. firms as especially troublesome. These would include remaining regulatory and administrative rigidities in the money market; prohibitions on certain activities such as foreign exchange trading by securities companies; and other miscellaneous matters such as withholding taxes on interest income to foreigners and limitations on the ability to engage in short selling. While all of these policies apply equally to U.S. and Japanese firms, certain U.S. firms allege that, in practice, they are more binding on U.S. firms since they impinge on activities in which U.S. firms have special expertise.

There is, however, another important area of regulatory policy which results in important differences in treatment and that relates to capital adequacy standards for banks, a subject which is covered in greater detail later in this statement.

C. Limitations on Acquisitions: In most foreign countries, acquisitions of banks or other financial concerns by U.S. firms are either limited by law or regulation or are very difficult to achieve as a matter of practice. In Japan, the most significant current barrier to acquisition may be price, but whatever the reason, it is easier for foreign entities to acquire U.S. banking and financial institutions than is the reverse.

D. Invisible Barriers: There are a host of considerations ranging from language and custom to relationships with bureaucrats which can be barriers to market participants in any foreign center, and Japan is certainly no exception. Indeed, some observers would contend that so-called invisible barriers in Japan are more of a problem than is the case in other international financial centers.

IV. The Record of the Past Six Months

Over the past several months, Japanese authorities have implemented several important policy changes in furtherance of the goal of more open and more competitive financial markets in Japan. These steps included the following:

A. Deposit Deregulation: Effective April 6, 1987, the Ministry of Finance (1) reduced the minimum size of time deposits which are free of interest rate ceilings from 300 million yen (about $2 million) to 100 million yen (about $700,000); and (2) reduced the minimum size of money market certificates from 30 million yen (about $200,000) to 20 million yen (about $150,000). Both the new and the old regulations apply equally to domestic and foreign institutions.

In the area of deposit deregulation and greater money market flexibility, national treatment considerations are not the central issue since Japanese institutions operate under the same rules as foreign institutions. Rather, the money market issues are more a matter of greater market efficiencies in a setting in which firms

with special market expertise -- Japanese or others -- can take full advantage of those skills. While the extent of money market deregulation achieved is important, further steps are needed. This area will be one of those considered at the next round of so-called yen-dollar discussions between the U.S. Treasury and Japanese authorities planned for the near future.

B. Securities Affiliates of U.S. Banks: In March 1987, the Ministry of Finance formally advised that it had amended its regulations to permit U.S. banking organizations to have securities affiliates in Japan, subject to the same terms and conditions that apply to securities affiliates of European universal banks. What is particularly significant about this action is that it provides access to Japanese securities markets for U.S. banks even though such access is not available to Japanese banks. It would also permit these U.S. bank affiliates in Japan a wider range of securities activities than is permissible here in the U.S.

At present, there are three U.S. banks with securities affiliates in Japan through their U.K. merchant banks and I know of four U.S. banking organizations that are seeking to obtain licenses for securities affiliates under the arrangements noted above. The requests are in the advanced stage of review such that formal applications will soon be filed with final approvals expected in the near term. Of course these arrangements would also be subject to approval of U.S. bank regulatory authorities.

C. Access to the Government Securities Market: Prior to 1978, all Japanese government debt was sold by the so-called syndicate method whereby the terms of such debt issues were negotiated by the government and a syndicate of financial companies. Each member of the syndicate, in turn, received a predetermined share of the securities issue. The syndicate method of issuing government debt is still the dominant method of debt issuance in a number of countries, including a few major industrial countries (See Appendix IV). It is also the general

procedure followed by Federal government agencies here in the United States as well as the prevailing method for issuing most corporate and municipal debt.

Because most Japanese government debt was issued in this fashion and because U.S. firms were generally not part of the syndicate, U.S. firms did not have meaningful direct access to new issues of Japanese government securities. De facto limits on access to new issues of government securities placed U.S. firms at a competitive disadvantage not just in the government market itself but in other markets as well because of the important linkages between government securities and other securities.

In response to this situation, the Japanese authorities have taken several steps. First, for a number of short- and intermediate-term issues, they have fully adopted the auction method such that about 35 percent of new issues in 1986 were auctioned. In addition, the Japanese

authorities have eliminated the requirement of having an account at the Bank of Japan in order to be eligible to bid in such auctions. However, the 10- and 20-year maturities are still issued by the syndicate method -- a fact that is especially important in the case of the 10-year bond which is the largest and most important of the issues, especially in terms of secondary market trading.

In these circumstances, effective April 1, 1987, the syndicate has agreed to increase the total share of the new issues available to foreign securities firms from 1.19% to 5.725% of the share available to securities houses and it has raised the shares available to individual foreign companies from 0.07% to a maximum of one percent. While still small, we understand that these shares for the foreign group as a whole are commensurate with the overall size of foreign securities firm secondary market trading in yen government bonds. Finally,

as discussed below, the Ministry of Finance apparently is considering additional steps which would further open the market for Japanese government debt to foreign market participants.

Taken in the context of measures initiated by the Japanese authorities over the past several years, and taken in the context of further steps that may be under consideration at the present (see below), these latest initiatives by the Japanese strike me as helpful and as reflective of continued good faith efforts to move ahead with financial market liberalization. To be sure, further effort on a variety of fronts is needed.

V. Looking to the Future

In looking to the future, there is a clear need to reduce both the specific points of friction referred to in this statement and, more importantly, to deal with the underlying problems which are at the heart of current tensions in the international economic and financial arena.

Insofar as particular problems relating to the activities of U.S. banks and securities companies in Japan are concerned, I would hope and expect that the Japanese would continue to move forward with efforts to liberalize their

domestic financial markets, thereby providing greater competitive opportunities for U.S. firms in the Japanese marketplace. As I see it, there are four specific areas that warrant particular attention:

1. Greater access to the Japanese government securities market. In this area, I believe that the Japanese authorities may be considering one or more possible further steps including: (1) the offering through auction of new maturities of intermediate and longer-term issues which would work in the direction of increasing the percentage of issues sold through auction; (2) shifting the 20-year issue from a syndicate to an auction; and (3) the use of something like the U.S. non-competitive tender system in the 10-year maturity which could provide larger shares to U.S. market participants while still preserving the syndicate framework for that issue. Needless to say, I would welcome initiatives along these lines which could pave the way to the day in which the auction method of issuing debt was the general practice. In turn, this would

be an important step in the direction of establishing market practices in the Japanese government securities markets that are more in line with practices here and in London.

2. Increased representation in the Tokyo Stock Exchange: As I understand it, plans are now underway to expand the number of seats -- including seats held by foreigners -- on the Tokyo Stock Exchange next spring when new facilities and computer capabilities will be in place. Procedurally, this will entail the establishment of a membership committee within the exchange in the near term. I am led to believe the committee's deliberations should be completed and its recommendations made to the full exchange membership late this year. Here too, I expect that the result of these deliberations would be some added representation of U.S. firms in the exchange. I would also hope the time schedule for this process could be accelerated, but I do understand the practical problems involved.

3. Money Market Liberalization: As noted earlier, the next round of discussions between the Japanese authorities and U.S. Treasury representatives are scheduled to take place shortly. Those discussions will, among other things, focus on what further steps might be taken to reduce rigidities in the Japanese money market which, in turn, can make it easier for U.S. institutions to compete in the market and thereby more easily fund Japanese-based lending and securities market activities in the local currency.

4. Bank Capital Standards: While the areas mentioned above are important, the single item on which I place greatest emphasis relates to bank capital adequacy standards and specifically to the goal of moving Japanese bank capital standards into closer alignment with emerging international standards.

Efforts to establish international standards for bank capital adequacy have been underway within the Bank for

International Settlements for about three years. This effort was undertaken by the G-10 central bank governors in recognition of the fact that both competitive and prudential considerations pointed to the need for such standards as the globalization of banking was proceeding very rapidly. While efforts are proceeding in the BIS and through other multinational channels, the U.S. and the U.K. reached agreement earlier this year on a joint approach to capital standards in our respective countries. Such proposals were made available for public comment in January and final rules are expected to be put in place sometime later this year.

Senior officials of both the Bank of Japan and the Ministry of Finance have indicated that they agree in principle that Japanese bank capital standards should, in due course, be brought into broad alignment with international standards. And, preliminary discussions between senior Federal Reserve, Bank of England and

Japanese officials have been held on the subject. Further discussions are scheduled in the near term.

Achieving the needed degree of convergence in this area will be much more difficult in the case of Japan than was true with the U.K. because the starting points with Japan are much further removed from prevailing practices in the U.S. and the U.K. Moreover, as we have seen with U.S. banks, even relatively minor changes in this area can be controversial. Thus, while achieving convergence with the Japanese will be a long and difficult task. Progress along those lines is important.

As I see it, the four areas I have mentioned above are the clear priorities. Given the progress that has been made in the past, I am confident that efforts to move ahead in these and other areas will prove fruitful and mutually beneficially. Partly for this reason, I am opposed to legislative efforts along the lines of the so-called "primary dealer" amendment that was incorporated into the trade bill passed by the House or as recently proposed by Senators Proxmire and Riegle. As I see it, such legislation could have the effect of stalling rather than accelerating discussions and negotiations, while

possibly producing unintended adverse side effects -- both in terms of general attitudes toward market liberalization and attitudes regarding capital inflows to the U.S. It would be one thing to consider a legislative approach in an environment in which progress and good faith discussions were not taking place. However, this is not the current situation.

Taking a longer-term view of the situation, Japan faces many of the same problems in the financial area that we are so conscious of here in the United States. Namely, much of its overall banking and financial structure -- as well as the regulatory and supervisory apparatus associated with that structure -- were not designed for the current international market environment. The Japanese will have to come to grips with these issues just as we and others will have to do the same. In the case of the Japanese, coming to grips with these larger issues could also yield a situation in which constructive change on the Japanese side is forthcoming at their initiative, as a part of that larger process, rather than as a result of time-consuming and, at times, difficult discussions of specific points of concern and friction. In this regard, the point should also be stressed that problems of the nature discussed in this statement -- specific or generic -- are by no means limited to Japan.

In concluding, Mr. Chairman, let me return briefly to where I started -- with the economic fundamentals. If we are to be successful in winding down our external imbalances in an orderly way, we in the United States must live up to our responsibilities -- which means learning to live within our means. To be sure, actions abroad are needed and needed badly. But, as we call on others to open their markets and stimulate their economies, let us not lose sight of our end of the bargain. Our federal budgetary affairs -- despite the efforts of this committee and others -- are still in a state of disarray and must be put in order; the need for broad-based reform in our own financial structure must be addressed; pressing questions as to the degree of underlying competitiveness of our industrial sector must be answered; and, patterns of savings and investment in our domestic economy must be brought into line with the longer-run needs of rising productivity and standards of living. If we are to come full circle in restoring balanced growth here at home and in the world more generally, we must also avoid any renewed outburst of inflation which would undermine prospects on all fronts. Moreover, balanced growth in the world economy will also provide a much more constructive environment within which legitimate issues regarding financial market practices and evolution can be resolved here and elsewhere.

APPENDIX I

Selected Information on Activities of Major U.S., U.K. and Japanese Financial Institutions Abroad

Exhibit I	Permissible Activities by Type of Institution under the Effect of Host Country Regulation
Exhibit II	Banking Operations of Foreign Banks in the United States
Exhibit III	Summary Data on Major U.S., U.K. and Japanese Banking Operations Abroad
Exhibit IV	U.S. Banking Presence in Japan
Exhibit V	U.S. Banking Presence in the United Kingdom
Exhibit VI	Selected Data on U.S. Securities Firms in Japan and Japanese Securities Firms in the United States
Exhibit VII	Major Japanese Acquisitions/Investments in U.S. Financial Firms

Exhibit I

Permissible Activities by Type of Institution

Activity	Type of Institution											
	(1) US Bank Holding Co		(2) Japanese City Bank		(3) UK Clearing Bank		(4) US Securities Firm		(5) Japanese Securities Firm		(6) UK Merchant Bank	
Banking License	NY	YES	NY	YES	NY	YES	NY	S	NY	S	NY	S
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	YES	TO	YES	TO	YES	TO	NO	TO	NO	TO	NO
Dealing in Corporate Securities	NY	NO	NY	NO	NY	NO	NY	YES	NY	YES	NY	YES
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	S	TO	NO	TO	S	TO	YES	TO	YES	TO	YES
Foreign Exchange Dealing	NY	YES	NY	YES	NY	YES	NY	YES	NY	YES	NY	YES
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	YES	TO	YES	TO	YES	TO	NO	TO	NO	TO	NO
Dealing in U.S. Treasuries	NY	YES	NY	YES	NY	YES	NY	YES	NY	YES	NY	YES
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	NO	TO	NO	TO	NO	TO	YES	TO	YES	TO	YES
Dealing in UK Gilts	NY	NO	NY	NO	NY	NO	NY	YES	NY	YES	NY	YES
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	NO	TO	NO	TO	NO	TO	YES	TO	YES	TO	YES
Dealing in Japanese Gov't bonds	NY	NO	NY	NO	NY	NO	NY	YES	NY	YES	NY	YES
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	YES	TO	YES	TO	YES	TO	YES	TO	YES	TO	YES
Trust Bank	NY	YES	NY	YES	NY	YES	NY	S	NY	S	NY	S
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	YES	TO	NO	TO	YES	TO	NO	TO	NO	TO	NO
Account at the Central Bank	NY	YES	NY	YES	NY	YES	NY	S	NY	S	NY	S
	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES	LO	YES
	TO	YES	TO	YES	TO	YES	TO	YES	TO	YES	TO	YES

NY = New York
LO = London
TO = Tokyo
YES = Full license permitted.
NO = Not generally permitted.
S = Permitted only through special purpose companies, such as a 50% owned affiliate or a nonbank bank.

Banking Operations of Foreign Banks in the United States

Total U.S. banking assets (in billions)[1] of major foreign countries as of December 31
Expressed as a percentage of total U.S. banking assets

Countries	1982		1983		1984		1985		1986	
	$	%	$	%	$	%	$	%	$	%
Japan	113.0	5.0%	126.0	5.0%	151.3	6.1%	181.3	6.1%	245.4	8.7%
Canada	22.1	1.0%	27.8	1.2%	38.1	1.5%	42.3	1.7%	42.4	1.5%
United Kingdom	52.2	2.5%	53.0	2.3%	51.4	2.0%	61.2	2.4%	40.6	1.5%
Italy	14.3	.7%	17.5	.8%	23.9	.9%	29.1	1.1%	36.4	1.4%
Switzerland	13.0	.6%	13.1	.6%	15.3	.6%	18.3	.7%	24.5	.9%
France	16.6	.8%	16.2	.7%	18.3	.7%	20.7	.8%	22.4	.8%
West Germany	8.9	.4%	7.4	.3%	7.6	.3%	8.8	.4%	11.0	.4%
All other countries	60.5	3.0%	70.9	3.1%	72.4	2.9%	97.2	3.8%	103.9	3.8%
Total U.S. banking assets of foreign banks	$300.6	14%	$331.9	14%	$378.3	15%	$458.9	18%	$526.6	19%
Total assets of domestic banking institutions[2]	$1,821.1	86%	$1,986.5	86%	$2,076.8	85%	$2,098.7	82%	$2,285.9	81%
Total U.S. banking assets[2]	$2,121.7	100%	$2,318.4	100%	$2,455.1	100%	$2,557.6	100%	$2,812.5	100%

1/ Amounts for each country include the total U.S. banking assets of all banks from that country, namely the aggregate of the assets of their U.S. branches, agencies, bank subsidiaries, Edge Act and Agreement corporations and New York State-chartered investment companies (called Article XII corporations).

2/ Includes the total consolidated assets (domestic and international) of all U.S. banks.

Exhibit III

Summary Data on Major U.S., U.K. and Japanese Banking Operations Abroad

1986 versus 1984

	Number of Banks		Assets		Employees
	1986	1984	1986	1984	1986
U.S. Banking Presence in Japan	19	21	$ 19 billion	$ 20 billion	2,700
U.S. Banking Presence in the U.K.	43	43	$132 billion	$128 billion	11,000
Japanese Banking Presence in the U.S.	28	26	$245 billion	$151 billion	18,000
U.K. Banking Presence in the U.S.	10	11	$ 41 billion	$ 51 billion	NA

Sources: Sources include "Structure Data for U.S. Offices of Foreign Banks by Type of Institution", computerized data prepared by the Board of Governors of the Federal Reserve System. Data on U.S. banking operations in Japan and the U.K. reflect year-end 1985 levels. Assets include branches, agencies and subsidiaries. Employment data are partially estimated.

U.S. Banking Presence in Japan
Number of U.S. Banking Organizations, Japanese Units and their Total Assets
$ in Billions
As of December 31

	1981		1982		1983		1984		1985		1986		Increase Decrease 1981-1985	
	#	$	#	$	#	$	#	$	#	$	#	$	#	$
U.S. Banking organizations in Japan	22	21.6	22	20.6	22	22.0	21	19.5	19	18.7	n/a	n/a	- 3	- 2.9
Branches	31	21.2	31	20.1	31	21.5	31	19.0	30	18.0	30	19.7	- 1	- 3.2
Controlled-subsidiaries	5	.4	10	.5	12	.5	12	.5	14	.7	n/a	n/a	+ 9	+ .3
Total	36	21.6	41	20.6	43	22.0	43	19.5	44	18.7			+ 8	- 2.9
Total Foreign exchange contracts outstanding at branches		32.9		51.5		51.8		51.7		66.8				+33.9

Exhibit IV

Exhibit V

U.S. Banking Presence in the United Kingdom
Number of U.S. Banking Organizations, U.K. Units and their Total Assets
$ in Billions
As of December 31

	1981		1982		1983		1984		1985		Increase/ Decrease 1981-1985	
	#	$	#	$	#	$	#	$	#	$	#	$
U.S. Banking organizations in the UK	43	163	44	150	43	151	43	128	43	132	0	- 31
Branches	59	145	60	141	52	133	61	111	67	112	+ 8	- 33
Controlled subsidiaries	132	18	108	9	106	18	99	17	110	20	-22	+ 2
Total	191	163	168	150	158	151	160	128	177	132	-14	- 31
Total Foreign exchange contracts outstanding at branches		275		294		272		182		238		- 37

Exhibit VI

Selected Data on U.S. Securities Firms in Japan and Japanese Securities Firms in the United States

1986 versus 1984

	Number of Firms		Capital		Employees	
	1986	1984	1986	1984	1986	1984
U.S. Securities Firms in Japan	12	7	$450 million	$ 35 million	1,500	450
Japanese Securities Firms in the U.S.	11	9	$400 million	$100 million	1,450	450

Sources: Capital and staffing levels are based on informal surveys of market participants and various other sources. Amount of capital shown reflects the capital of the affiliate with the securities license. This exhibit does not include U.S. bank-owned British securities affiliates with licenses in Japan.

Exhibit VII

Major Japanese Acquisitions/Investments in U.S. Financial Firms
(listed in chronological order)

1. The Tokai Bank, Ltd.

   Acquired company: Continential Bank, Alhambra, California (assets of $170 million) in 1981.

2. The Dai-Ichi Kangyo Bank, Ltd.

   Acquired company: Japan California Bank, Los Angeles (assets of $131 million) in 1981.

3. The Fuji Bank, Ltd.

   Acquired company: Walter E. Heller and Company, Chicago (assets of $2.8 billion) in 1984.

4. The Mitsubishi Bank, Ltd.

   Acquired company: BanCal Tri-State Corporation and its subsidiary, The Bank of California, N.A. (assets of $2.2 billion) in 1984.

5. The Industrial Bank of Japan, Ltd.

   Acquired company: J. Henry Schroder Bank and Trust Company, New York (assets $1.9 billion) in 1985 from British merchant bank.

   Acquired company: Aubrey G. Lanston & Co., New York, a government securities dealer, in 1986.

6. The Sanwa Bank, Ltd.

   Acquired company: Certain leasing subsidiaries of Continential Illinois Corporation (assets $647 million) in 1984.

   Acquired company: Lloyds Bank of California from Lloyds Bank, London, England (assets $3.1 billion) in 1986.

7. The Sumitomo Bank, Ltd.

   Fourteen percent of Central Pacific Bank, Honolulu (assets of $297 million) in 1977.

   Nonvoting equity investment of up to $500 million in Goldman, Sachs & Co., New York, in 1987.

8. Nippon Life Insurance Company

   Thirteen percent interest in Shearson Lehman Brothers, New York, for $538 million in 1987.

APPENDIX II

Primary Dealers in U.S. Government Securities

The market for U.S. Government bills, notes and bonds is the most active capital market in the world. Thousands of investors are daily participants, buying and selling billions of dollars of outstanding "Treasuries". The Federal Reserve System is a major participant in the Government securities market through the Federal Reserve Bank of New York, which buys and sells U.S. Government securities on behalf of the Federal Open Market Committee. These open market operations are the central bank's primary tool for conducting monetary policy. The Federal Reserve Bank of New York is also an active participant in the market in its capacity as agent for many foreign central banks.

The firms with which the Federal Reserve Bank of New York conducts its business are referred to as "primary dealers". There are currently 40 such primary dealers (see attached list). The primary dealers are the major market makers for U.S. Government securities and, as such, are the vital link between the Treasury's debt managment activities and the overall market for U.S. Government securities here and abroad.

The number of primary dealers has increased over time, from twenty-nine in 1975 to thirty-six at the beginning of 1986 and forty today. There is wide diversity within the current group of firms. About half of the dealers are diversified securities firms or affiliates of such firms. Seventeen are banks or affiliated with banks. Others are firms that specialize in dealing in government securities. Thirty-two of the dealers are controlled by U.S. interests and eight are foreign-owned. These eight firms represent five different countries: Australia, Canada, Hong Kong, Japan and the United Kingdom. Among the 32 U.S.-controlled firms, about one-fourth have some form of minority interest by foreign investors, representing several additional countries.

Foreign ownership of primary dealers is not new. However, the increased number of foreign-owned firms recently participating in this market reflects the increased international character of the market and increased importance of foreign investors as holders of U.S. Government securities. In fact, of the more than fifteen firms who have expressed at least some interest in attempting to establish a business relationship with the Federal Reserve Bank of New York, over half of the firms are foreign-owned. Therefore, at this point, firms domiciled in most of the G-10 countries, plus Australia and Hong Kong, either have an interest in a primary dealer or are considering steps that would lead in that direction.

The amount of business conducted by foreign-owned primary dealers is widely distributed. The combined volume of the eight foreign-owned primary dealers constitutes about 15 percent of total primary dealer volume which, in turn, represents only a portion of the overall secondary market for U.S. Government securities. The customer volume of firms owned by Japanese firms accounts for about one-half of the volume of all foreign-owned firms.

May 1987

LIST OF THE PRIMARY GOVERNMENT SECURITIES DEALERS REPORTING TO THE MARKET REPORTS DIVISION OF THE FEDERAL RESERVE BANK OF NEW YORK

Bank of America NT & SA
Bankers Trust Company
Bear, Stearns & Co., Inc.
Carroll McEntee & McGinley Incorporated
Chase Manhattan Government Securities, Inc.
Chemical Bank
Citibank, N.A.
Continental Illinois National Bank and Trust Company of Chicago
Daiwa Securities America Inc.
Dean Witter Reynolds Inc.
Discount Corporation of New York
Donaldson, Lufkin & Jenrette Securities Corporation
Drexel Burnham Lambert Government Securities Inc.
The First Boston Corporation
First Interstate Capital Markets, Inc.
First National Bank of Chicago
Goldman, Sachs & Co.
Greenwich Capital Markets, Inc.
Harris Trust and Savings Bank
E. F. Hutton & Company, Inc.
Irving Securities, Inc.
Kidder, Peabody & Co., Incorporated
Kleinwort Benson Government Securities, Inc.
Aubrey G. Lanston & Co., Inc.
Manufacturers Hanover Trust Company
Merrill Lynch Government Securities Inc.
Midland-Montagu Government Securities, Inc.
J. P. Morgan Securities, Inc.
Morgan Stanley & Co. Incorporated
Nomura Securities International, Inc.
Paine Webber Incorporated
Wm. E. Pollock Government Securities, Inc.
Prudential-Bache Securities, Inc.
Refco Partners
L. F. Rothschild, Unterberg, Towbin, Inc.
Salomon Brothers Inc.
Security Pacific National Bank
Shearson Lehman Government Securities, Inc.
Smith Barney Government Securities, Inc.
Thomson McKinnon Securities Inc.

NOTE: This list has been compiled and made available for statistical purposes only and has no significance with respect to other relationships between dealers and the Federal Reserve Bank of New York. Qualification for the reporting list is based on the achievement and maintenance of reasonable standards of activity.

Market Reports Division
Federal Reserve Bank of New York
December 11, 1986

APPENDIX III

Chronology of Actions Taken To Liberalize Japanese Financial Markets

1987 Announced policy to allow U.S. commercial banks to expand into Japanese securities markets through overseas affiliates under the same rules applied to other foreign banks.

Further deregulated large denomination deposit instruments, including (1) lowering of time deposits free of interest rate limitations from 300 million yen to 100 million yen and (2) lowering minimum of money market-determined interest rate accounts (MMCs) from 30 million yen to 20 million yen.

Government bond syndicate (1) enlarged share of foreign securities firms and (2) eased the requirements for foreign banks to join the syndicate from having a representative or branch office in Japan from at least ten years to five years.

As of March 1987, 35 foreign securities firms were licensed in Japan, including 12 U.S. securities firms.

Eased qualifications for participating in auctions of medium-term government bonds (participants no longer need to first have current accounts at the Bank of Japan), increasing the number of eligible foreign securities firms from two to 23.

Announced that foreign securities firms will have the option to expand in Japan through subsidiaries rather than just branches.

First foreign firms awarded discretionary fund management licenses.

1986 Approved licenses for nine foreign banks (including six U.S. banks) to establish trust banks in Japan, where eight Japanese trust banks operate.

First foreign securities firms joined the Tokyo Stock Exchange (TSE) as full members. Of the six seats that went to foreign firms announced in November 1985, four went to U.S.-owned firms.

Other foreign securities firms and banks permitted to join the TSE as special members in the long bond futures market; four of the five foreign securities firms that participate as special members on the TSE are U.S.-owned firms.

Accounts at the Bank of Japan first approved for subsidiaries of U.S. securities firms.

Foreign and domestic securities firms permitted to deal in bankers acceptances.

Establishment of offshore International Banking Facilities in Japan.

Eased restrictions on Japanese companies investments in foreign securities, permitting 30 percent of new assets, up from 10 percent, and also expanded types of eligible investments.

Changed leverage restrictions on foreign securities firms to permit option to operate under same regulations as apply to Japanese securities firms.

Liberalized Euroyen market through (1) reduction in the time limit on resale of issues into Japan from 180 to 90 days, (2) expansion of the number of rating agencies, and (3) permission granted foreign banks to issue Euroyen bonds for the first time.

Removed financial institutions foreign exchange swap limits.

Introduced a short-term (six months) Japanese Government security.

Permitted participation of non-Japanese banks and securities firms in the auction of the six-month government bonds. Eight U.S. banks and eight U.S. securities firms participated.

Most foreign banks that applied now have licenses to deal in Japanese Government bonds.

Lowered minimum denomination of CDs free from interest rate ceilings to 300 million yen.

1985 Establishment of unsecured call money market for foreign banks.

Deregulation of ceilings on issuance of MMCs, from maximum of 75 percent to 150 percent of yen assets.

Establishment of bankers acceptance market in June 1985.

Easing of restrictions on certain investments in foreign securities.

By the end of December 1985, eleven U.S. securities firms had obtained securities licenses compared to seven at year end 1984.

Withholding tax on Euroyen bonds issued by Japanese residents and held by foreigners eliminated.

Enlargement of ceilings on CD issuance from 75 percent of net worth to 150 percent of each bank's net worth.

Removal of interest rate ceilings on large denomination time deposits over 1 billion yen and over 2 years maturity.

1984 First permitted foreign banks to become members of the 10-year Japanese Government bond syndicate.

Private corporations and state and local governments and agencies first authorized to issue Euroyen bonds.

Qualified foreign banks permitted to operate as paying agents in Japanese Government bonds.

Elimination of real demand rule in foreign exchange.

Removal of limits on oversold spot foreign exchange positions of banks.

Eased requirements on overseas yen lending from Japan by banks.

Removed restrictions on the lead and co-lead management of issues of Euroyen bonds.

APPENDIX IV

Methods For Issuance of Government Securities in Selected Countries

I. Australia

Australian Government bonds are allotted using an auction process instituted in 1982. About seven to eight tender offers are made each year, with a five week period between announcement and settlement. The Reserve Bank of Australia is the government's agent in administering the tenders.

Any institution can bid in the auction, whether it is foreign or locally owned. Both competitive and non-competitive bids can be made in a minimum size of A$100,000 and A$1,000, respectively. Competitive bidders must register with the Reserve Bank and must also be eligible to hold Inscribed Stock under the Commonwealth Inscribed Stock Act of 1911. Non-competitive bidders need not register.

II. Canada

There are three categories of government securities in Canada: direct marketable long-term bonds, Treasury bills, and Canadian savings bonds. At the end of 1986, outstanding marketable bonds totalled about $65 billion compared to about $38 billion in bills and $33 billion in savings bonds.

Long-term Canadian Government securities are issued through a selling group of primary distributors through the Bank of Canada. Foreign institutions, except for four U.S. securities firms grandfathered under 1971 regulations, are not permitted to participate as primary distributors. Foreign banks acquiring Canadian primary distributors have lost that status.

Some sales of short-term marketable bonds (under three-years maturity) are conducted through auctions. Bidding is open only to primary distributors of marketable bonds and the Bank of Canada.

Treasury bills are auctioned to a group consisting of Canadian and foreign-owned banks, but security firm participation is limited only to those firms registered with the Ontario Securities Commission. This limits participation of foreign securities firms to the four grandfathered U.S. firms.

III. France

French public debt instruments currently range in maturity from short-term bills and 2-year notes to medium- and long-term bonds, some with maturities of 25 years. All financial instruments of the Federal Government are now issued through public auctions, including the regular 13-, 16- and 52-week bill auctions begun in early 1986. Foreign institutions may participate in government auctions.

IV. Germany

Government bonds in Germany are issued through a syndicate (the Federal Bond Consortium) comprised of about 72 domestic members and 19 foreign firms; auctions are not used. The Bundesbank is the syndicate lead manager. The central bank holds about 25 percent of the issues which it uses to smooth out daily price fluctuations.

Foreign banks were first invited into the Federal Bond Consortium in 1986. As of June 1986, nineteen foreign bank subsidiaries, including four U.S.-owned firms, were added to the consortium. The share received by foreign firms is fixed, with these firms currently receiving a total of 20 percent of the Federal bond issues.

V. Hong Kong

There is essentially no Hong Kong government securities market.

VI. Japan

The Japanese Government issues bonds with various maturities from less than six months to 20 years and has used various methods of issuance, including syndicates, private placements and auctions.

The 10-year bond is the largest issue of Japanese Government bonds. These bonds are issued through an underwriting syndicate of over 750 participants which include more than 600 banks, about 100 securities firms, insurance companies and other institutions. Both foreign and domestic firms participate in the syndicate. Negotiations as to amount and price are conducted with the Ministry of Finance by twelve committee members which represent classes of syndicate members. Allocation of the issues to each syndicate member is determined by the syndicate. Because individual allocations are based largely on the size of operations and experience in Japan, foreign securities firms and banks receive a small fraction of each issue. Twenty-year Japanese Government

bonds as well as five-year discount bonds are underwritten by similar syndicates.

In 1978, the Japanese authorities introducted the auction process for bonds with maturities of 2, 3 and 4 years. Foreign banks were permitted to bid in the auctions in 1984. Until recently, a securities firm had to be a member of the 10-year syndicate to participate in the auctions as well as have a current account with the Bank of Japan. In April 1987, the Ministry of Finance eliminated the current account requirement, allowing 23 foreign securities firms to engage in the bidding, up from two foreign securities firms. Japanese Government bonds with maturities of less than six months were introduced in February 1986 through the auction method. Bidders in the auctions include both foreign banks and foreign securities firms with licenses to deal in Japanese Government bonds. Bills are issued three days a week at a fixed rate that is lower than prevailing market rates. Most of the bills are underwritten by the Bank of Japan.

VII. United Kingdom

New issues of U.K. Government bonds are normally made through a tender pricing system. The minimum price for a sale is set by the Bank of England in line with market prices at the time of announcement. Successful tender parties receive stock at the minimum price bid. If prices offered are below minimum, surplus stock may be taken up by the Bank of England acting as underwriter and may be subsequently issued 'on tap' in the secondary market. Occasionally, new stocks, or taps of existing stocks, are issued directly to the Bank of England. The Bank of England may then sell 'tranchettes' to the market, small additional supplies of stocks which are normally used to satisfy market demand for gilts. The sale of gilts is not restricted to a syndicate of only financial institutions, although in practice, the 27 market-makers newly established in the gilt market are expected to be the major purchasers.

At present, the Bank of England sells about Stg 1,000 million of gilts each month. The Bank of England has recently announced that a series of experimental auctions of gilts will begin in May 1987 which will be more like the U.S. system but with the Bank of England retaining the right to not allot all the stocks on offer. Institutions and other investors will be able to bid directly in the auctions.

May 1987

Chairman CHILES. We are delighted to have Senator Domenici with us.

Senator DOMENICI. Mr. Chairman, I compliment you for calling this hearing. I think the issue is a very vital and important one.

OPENING STATEMENT OF SENATOR DOMENICI

Senator DOMENICI. Mr. Chairman, first let me say to our witnesses that I regret that we have to compress this hearing into a very short time. As I am sure the chairman has already indicated he and I are knee deep in budget-making on the Senate floor.

But I thank him for organizing this hearing. And I thank you for coming and for all of your thoughtful testimony.

I really don't know much about this issue. So I am really here to learn. But I would like to make a few observations that I believe are relevant to the larger issue of "smart" trade policy as opposed to "free" trade policy.

My own State of New Mexico does not have major financial institutions in the same sense as they exist on Wall Street. Much of what goes on in financial markets is far removed from the daily lives of most New Mexicans, although they certainly suffer the effects of higher interest rates and instability in financial markets.

What is very real to New Mexicans, however, is what appear to be actively protectionist policies by the Japanese in semiconductors and other "knowledge-based" industries. The highest level Japanese trade negotiator, Mr. Kuroda, recently told U.S. Government officials that our supercomputers would not be bought in Japan even though our computers are vastly superior to anything they have.

With these kinds of statements, it is clear that we do not have "free" trade policy. But what concerns me most is that we don't appear to have "smart" trade policy either.

The Japanese have liberalized their financial markets to make it easier for Japanese to buy dollars but not to enable the rest of the world to do transactions in yen. From their point of view, this is "smart" trade policy.

Now we are opening our financial market not only to give them a privileged underwriting position, but also so that they can help set American interest rates. This to my mind is "stupid" trade policy.

I look forward to your testimony this morning on these issues. The Senate will soon consider trade legislation of its own and I hope that your testimony will help the members of this committee make informed judgments.

Chairman CHILES. Thank you, sir.

Mr. Corrigan, you have long been a believer in the concept of national treatment, that a foreign financial institution should be given equality of competitive opportunity with domestic firms in similar circumstances.

In fact it was national treatment considerations that led you to grant primary dealer statuses to Nomura and Daiwa securities companies. But in a letter that was released at the time of these approvals, you said—and I quote—"a continuation of the commit-

ment to national treatment must depend upon a steady flow of complementary policy actions in key markets abroad."

It seems that you are saying, without national treatment abroad, we will find it difficult to keep opening markets to foreign firms over here.

NATIONAL TREATMENT DEPENDS ON RECIPROCAL ACTIONS

Aren't you therefore really telling foreign countries that a continuation of national treatment depends upon some reciprocal actions overseas?

Mr. CORRIGAN. Well, I do not want to get into a debate about semantics here, but I would accept the broad thrust of your——

Chairman CHILES. Well, I am not trying to trick you by using the word——

Mr. CORRIGAN. I would accept the broad thrust of your comment, Mr. Chairman.

Chairman CHILES. Well, on the surface, the notion of national treatment sounds good. It may have been the right approach before the financial markets became so integrated, and the major financial corporations started doing business simultaneously with the major money centers. But it seems to me that it is time to insist on some kind of equivalent competitive opportunities in all major financial markets.

The abilities of our corporations to earn profits and to stay in business depend on being able to offer certain kinds of services and products. I do not see how it is fair to be shut out overseas from what we are best at, and, at the same time, to allow foreign corporations to have the freedom to export their strengths over here.

How can American firms compete in New York and London with Japanese and European businesses when we are not allowed to do what we are best at in Tokyo?

Mr. CORRIGAN. Let me back up a bit, if I may, Mr. Chairman. A national treatment doctrine, as I understand it, was one that was fundamentally directed at achieving, as a matter of law, the same treatment of a foreign entity in a local market, as local entities had in that same market.

And as I have said in my statement, if you look at the broad sweep of things—I think reasonable men could differ—but I think a case can be made that in strictly de jure terms, we probably have something quite close to national treatment, in those terms, in the three major markets that I have looked at in some detail—London, Tokyo, and New York.

And as I said, that produces anomalies. Our firms, in some cases, cannot do things that they may think they are particularly good at in Japan, but because of Glass-Steagall, and other restrictions here, they cannot do them here, either. Or British banks cannot do them here.

So many of the problems that we see are problems, but I am not sure they can be strictly viewed as national treatment problems.

Now, having said that, the fact does remain that notwithstanding a generalized situation of de jure national treatment, there are important barriers, which I have mentioned in my statement, to an effective competitive presence in, for example, Japanese markets.

"LAUNDRY LIST" APPROACH TO OPENESS

Chairman CHILES. In trying to establish a process to ensure market access, it seems there are different approaches. One might be called the "laundry list" approach.

We make a list of barriers that need to come down, and we hold out some kind of penalty if they are not removed. I have a lot of sympathy for this approach, but we have to keep in mind that we need pressure with regard to specific grievances, but I think we need to do something more. For one thing, financial markets are evolving so rapidly that any list will become dated very quickly, so we need some mechanism to spot these problems quickly so that pressure can be brought to bear.

I have drafted a bill that would establish an interagency task force made up of the Secretaries of Treasury and Commerce and the Chairman of the Federal Reserve Board, the FDIC, the Federal Home Loan Bank Board, SEC, and the Comptroller of the Currency. This group would monitor the access of U.S. financial firms to foreign markets, and if barriers were not removed the group would be empowered to prevent further entrance of these countries' firms into the American market.

My question to you is, don't you believe that we need some kind of a systematic approach to forcing market access, and wouldn't an interagency task force composed of our top financial officials be best qualified to monitor and act on that on an ongoing basis?

SOME APPROACH NEEDED TO KEEP EYE ON THINGS

Mr. CORRIGAN. Well, I certainly agree that the so-called laundry list approach is kind of a "black hole". You just do not know where the bottom is, or if there is a bottom. And, it is partly for that reason that I put particular stress on this bank capital question, because while that may sound like it is just part of a laundry list, the fact of the matter is that its impact is so broad based, and it applies basically to activities wherever they may take place—I do not consider that part of the usual laundry list.

So I have some inherent sympathy with the philosophy that you are stating, Mr. Chairman. I guess I want to reserve judgment on a specific proposal until I have had a chance to look at it.

I do think that, in principle, having some kind of a vehicle available to try to keep an eye on things, at the very least, makes some sense so long as that vehicle does not fall into that "black hole" that the vehicle, at least as you have described it, is trying to avoid.

I do not think that highly technical, and at times highly sensitive international discussions and negotiations, that frequently spill into the multilateral, not simply the bilateral, arena can be constrained by a black book of procedures.

Chairman CHILES. Last winter, an article called "The Japan Problem" appeared in the "Journal of Foreign Affairs", and the author, a European journalist who has lived in Japan for some 35 years, tells us how the Japanese economy is fundamentally different from that in the Western democracies.

He points out that their economy is run through a partnership between central bureaucrats and the entrepreneurs in which the

overriding objective is industrial expansion. To quote him, he says: "Freedom of the market is not considered a desirable goal in itself, but only one of several instruments for achieving the ultimate goal of industrial expansion. The economy is structurally protectionist, in the sense that all kinds of informal, if not official barriers to imports, must ensure that foreign competition will not undermine its aim".

Speaking specifically about financial liberalization, he says that the Reagan administration has eagerly presented Japanese financial liberalization measures as a fundamental breakthrough, when in fact they are designed to make Japanese financial institutions more internationally competitive, rather than to give foreign financial institutions a larger share of the Japanese market.

The question is: You have told us of the progress you believe is being made in opening of Japan's financial markets, but aren't we just being taken for a ride in the financial services area, just like what happened in many other sectors?

Isn't it time for us to demand that our firms receive equal competitive opportunities that the Japanese firms receive here?

Isn't it time to stop concentrating on small procedural changes that get us nowhere in terms of the bottom line? Look at our bank's position in Japan and how it has actually worsened in the last 3 years, even though there has supposed to have been liberalization.

Don't we need to start talking about a tough approach that demands some bottom line results, as well as procedural changes that, thus far, have been very ineffective?

Mr. CORRIGAN. There are some cross-currents here, and you have touched on several of them. Let me just back up and take your comment and question in two parts.

OPENNESS WILL BE MUTUALLY BENEFICIAL

The first part of that statement you read, as I heard it, the commentator was characterizing the Japanese economic system as whole as—I think the term was "closed and protectionist", or something like that—with a view toward industrial development, and that is all.

I think there may be something to that in a historical light, but to the extent there is, it is one of the reasons why I do think that this process that is taking hold on the financial side can be important in Japan, and that is, to the extent the financial markets are more open, that will be a mutually beneficial thing.

It will be beneficial to the Japanese as well as to others, just as we, as a nation, and others, have benefited from our openness in the financial sphere.

Now one of the lingering hopes that I continue to cling to, is that the progress being made in the area of more openness in Japan on the financial side can spill over, as people begin to realize that it is in their interest to see that more open environment.

Now on the second point, the extension of the comment, is there in some sense a danger that even if the openness quotient is equitable—if I heard your comment—isn't there some danger that it can backfire on us?

I do not really think so. I think that our financial firms can compete, and they ought to be able to. I do not see that as an unacceptable risk at this point at all, but I do think it points to getting closer than we are right now to some kind of basic parity in the way we compete, and that is, again, the thrust of several of my specific points for the future.

Chairman CHILES. In December 1986, you approved the application of Nomura Securities and Daiwa to become primary dealers. At that time you indicated that further approvals would depend upon complementary actions by foreign governments. You have said in your opening statement that progress has taken place.

What kind of progress will we need to see for the United States to be in a position to grant more primary dealerships to foreign firms, and what is the earliest possible date we could expect further approval of foreign firms to become primary dealers in Government securities?

IMPORTANT STEPS TAKEN IN SOME AREAS

Mr. CORRIGAN. Well, again, to take the first part of the question first, the particular initiatives that the Japanese authorities have taken in the last 2 or 3 months, the ones that I mentioned—deposit deregulation, securities licenses for U.S. banks, and further opening of their government securities markets—are of course the three major areas that were cited earlier on—three of the four, the fourth being the stock exchange question.

So I think it is fair to say that in three of the four areas important further steps have been taken.

As far as the future is concerned, I have touched in my statement on, again, the stock exchange question, and I hope we will see some pay dirt there.

I certainly hope we will see pay dirt insofar as the three areas mentioned above, such as these licenses for U.S. banks' securities affiliates actually being granted. I have every reason to believe that will happen.

But those are the kinds of things that I would be looking at in the immediate future. As far as timing is concerned, I do not have a very concrete answer for you, Mr. Chairman.

We will be looking at things over the next 6 to 8 weeks. In the natural course of things, certainly, I would not expect any decisions in that timeframe. So nothing is going to happen in the very near term, under any circumstances.

INTEREST RATE DECONTROL

Chairman CHILES. In the area of interest rate decontrol, even with the lastest move, around 70 percent of the deposits are still regulated.

We have not heard of a timetable for further deregulation. When do you think we can expect the regulated 70 percent to be freed up?

Mr. CORRIGAN. Well, again, as I said in my statement, Mr. Chairman, the next round of discussions on this subject between the Treasury and the Japanese authorities, I believe are tentatively scheduled for the next 3 or 4 weeks.

I do not think an exact date has been set but it is in the very near term, and the Treasury, and I am sure the Japanese, are right at this moment hard at work in developing an agenda for that meeting.

I do think this very subject that you mention will be the cornerstone of that meeting, and I fully expect that we will see some further progress.

I should say, in this particular context, if I may, that while there is a lot of room yet to go, there are I think some legitimate issues here on both sides of the equation.

I think one of the reasons why the Japanese authorities may be a little bit sensitive about going too fast, too far, in a thorough and complete liberalization of money-market arrangements is they fear, or they may fear, that it will compromise their ability to conduct their domestic monetary policies.

And I must confess that I have some sympathy with that concern. I do not have enough expertise to know precisely how great a concern it is or it should be, but the fact of the matter is, of course, that——

Chairman CHILES. Well, I do not have that expertise, either, Mr. Corrigan, but I know some of those concerns I have heard raised. For example, if they allowed a few more boxes of oranges to come in from Florida the Government would fall——

Mr. CORRIGAN. Well, I do not quite see that.

Chairman CHILES. Those mandarin growers would turn over the Government. I have heard the same thing in regard to cattle, and I have heard it in regard to rice, and, you name it, and I have heard those concerns.

Mr. CORRIGAN. Well, I certainly do not accept those arguments in the vast majority of cases, but this may be an area where the argument, as one central banker, has some legitimacy.

AUCTION OF 10-YEAR BONDS REFUSED

Chairman CHILES. Let me just ask you one other, and that is, in the access of foreigners to the Government securities market, we know that they have changed that from 1 percent to 5.7 percent. That is a big change, but that is much smaller than could be had through an auction system.

Thus far, they have refused auctions of their 10-year bonds, and my understanding is American executives in Tokyo tell us that amounts to about 75 percent of the auction in those 10-year bonds.

Mr. CORRIGAN. I am not sure what the 75 percent refers to. In 1986, if you take the total new issues of Japanese Government debt, something close to 35 percent of the grand total was marketed through an auction device.

Now, having said that, it remains true that the 10-year is the bellwether issue in the Japanese Government market. It is the largest by far, it is the absolute dominant instrument in secondary market trading, and, for those reasons, its importance transcends its size, even though the size itself is very big.

And it is true, that that issue, as things stand right now, is one in which the direct access to new issues is limited.

Chairman CHILES. Mr. Corrigan, the last questions I want to ask you concerns this. A strange thing has sort of happened on the way to this hearing.

AMERICAN EXECUTIVES IN TOKYO UNWILLING TO TESTIFY

A lot of our financial executives in Tokyo, who can cite chapter and verse, both on the progress that has been made, and on the remaining barriers, suddenly became unwilling to testify in public.

For that reason, we are deeply appreciative that Mr. Binney is here. His testimony is based on a speech that he gave in Tokyo this March; he has been willing to give his views on both sides of the Pacific.

But as part of the public record, we had an executive from Salomon Brothers' Tokyo office that was scheduled to testify, but the smart business executives in Washington and New York thought it would be better for Salomon to lie low.

What we have got here is that classic "free rider" problem. Let someone else get out in front, because anything they and the Government might accomplish will help all of us, but we will not take the lead. We are right behind you. Some of them are way behind.

On four occasions, our staff was told by an American financial executive in Tokyo that he would like to testify, but was fearful of the treatment that his firm might receive. He explicitly mentioned pending security licenses that might get lost along the way.

The problem is that these decisions in Japan are clouded in secrecy, and you do not know how the decision is made. It is hard to argue with the result.

With so many of our firms "running scared," we have to wonder about what is going on over there, and we have to, I think, start demanding free, open markets—not only openness about the markets, but openness about how these decisions are made.

Mr. Corrigan, how is it that we have gotten into such a situation that our executives will only be forthright on a background basis, and what can we do to assure that our executives are not afraid to come out and give us the information that we might need to make sound public policy?

Mr. CORRIGAN. Well, to begin with, obviously, I deeply regret that any individual associated with any company comes to the conclusion—whether the conclusion is warranted or not—that he, or she, is subject to some kind of a subtle, or other reaction by virtue of a willingness to speak out on issues.

As I said, I find it hard to pass judgment on the question as to whether that type of concern has any basis in fact.

I would like to think, as I know you would, that it does not. I should say, however, just for the record, that to the extent that U.S. firms may be inhibited about talking about their problems as they see them, they sure as hell are not shy about talking about them to me.

Chairman CHILES. Nor to me.

PROGRESS DOES NOT COME EASY WITH JAPANESE

Mr. CORRIGAN. Or you. So I think I have a reasonable idea as to what their concerns are, to begin with. But I think the general

point that you are making, I think has some validity, and I would like to see even greater progress made in terms of the atmospherics of the situation, as well as the substance of the situation.

I point to the progress--which I think is only fair—that the Japanese have made, but I am also mindful of the fact that it does not always come very easily, that it comes often through rather difficult, if not physically exhausting discussion and negotiation. It is not volunteered in the sense of up front, ahead of the wave—both in the substance of things, and in this more delicate area of the atmospherics of things. I would welcome an environment in which we are on the front of the wave, rather than catching it from behind.

Chairman CHILES. Senator Domenici.

Senator DOMENICI. Thank you, Mr. Chairman.

You cited oranges. I would just open my observations by telling you a little story, Mr. Chairman, about beef. You produce oranges; we produce a little bit of beef.

I had a very distinguished Japanese trade man in my office, and I was talking about the enormous tariff on beef, and a very interesting comment was, well, you don't really understand, Senator, we are a nation of fish eaters.

You understand, Mr. Chairman, that in Japan, beef is about $23 to $25 a pound. So my response was, Mr. So and So, I hope you understand, if beef was $23 a pound in America we would be fish eaters, too.

But frankly, Mr. Corrigan, I am not so sure that continued bashing will solve very many of our problems, and that some of the problems are our own.

But let me suggest—and I will get to your expertise in just a moment—but it just seems to me, yes, we have got some terrible problems, and our deficit, that is, our domestic Government deficit is too high. We have been living too high on the hog. Our corporate debt, and our individual debt is too high, and we think that is real neat, but the truth of the matter is, we were so strong going into this, that the world gives us an awful lot more credit than a lot of other countries, and so we just rocked on our merry way.

FOREIGN ECONOMIES DEPEND ON EXPORTS FOR SURVIVAL

But the other fact is that we are beginning to feel something in our country, and we are responding in a certain way, and we tend to want to call it unfair trade, but, the truth of the matter is, whatever you call it, between Japan, Germany, Taiwan, Korea, and a couple of others—their economies are now built almost totally on the proposition that they must export to survive.

Not only is it built on that, I say to you Mr. Chairman, but the truth of the matter is that a number of thier policies—the countries I have just described—a number of their domestic policies are built around the proposition that that is better for them than for them to consume more at home.

There is absolutely no question, that the Republic of West Germany has made a tradeoff, and they would rather have high unemployment and pay very monstrous benefits, and be a major exporter, than to consume more at home.

They are afraid of inflation. The Japanese, from the time they became an industrial country, decided they were going to build their economy on exports. Now it is impossible, absolutely impossible, for that to continue much longer when the overall world economy is not growing, and what is happening to the United States is that we have been stuffed, as one of the prime sources of all that excess, and we are taking a lot of it, and, here, at home, we are beginning to panic, and justifiably so.

We cannot justify some of the trade bills that are around on the basis of unfair trade. We can justify a portion of it, maybe 5–10 percent, but we cannot justify enormous tariffs on the basis that we are reciprocating to unfair trade.

What we are trying to reciprocate is this enormous imbalance. It is almost a new kind of mercantilism, and it is not going to work.

Now, frankly, we have to get our house in order, but during that period of time, it seems to me that this imbalance that I have just described is growing, and something has to be done about it.

JAPAN ENCOURAGED TO CONSUME MORE

We have had some efforts. We are trying to encourage them to consume more, change their tax laws, become more consumers rather than exporters.

Might I just stop there, and ask you, first, do you agree with that premise?, and, if you do, what do we do about it?

Mr. CORRIGAN. I think your diagnosis is pretty much right on the money, as a matter of fact. I might, again, quibble with a few words. You said, for example, Japan chose to develop an export economy. I do not think that is historically quite right, because they had so few natural resources they pretty much had to go that route.

They had to have the export capabilities in order to grow and develop at all. So, subject to a few quibbles, I think, your diagnosis is right on the mark.

I think that implication of your diagnosis is clear enough, and that is, we basically have two broad choices. The choices are do we seek to cope with the problem you have aptly described, in a framework in maintaining growth, or, do we seek to deal with it and choose to deal with it in an environment of recession and contraction?

Recession and contraction will produce adjustment, but it is not going to produce an adjustment that we are very happy with.

So it seems to me, that our only real choice is to go the other way. Now that in turn means, as I see it, at least two things.

One I touched on in my statement. It is going to take some time. And two, it is going to have to be a mutual process, our fate is not in our own hands, or is anybody else's.

It is a situation in which we are have to come to recognize that we will mutually benefit, all of us, from complementary initiatives, or we will mutually suffer from the lack thereof.

PROGRESS BEING MADE IN IMPORTANT AREAS

Now what I do not think we have quite caught onto yet, is that there are, I think, Mr. Senator, some "straws in the wind", that

suggest that maybe we have at least changed the trajectories in some very important areas.

For example, I make the point, rather aggressively, with my friends abroad—they do not seem to quite want to accept it yet—that we are talking about a budget deficit this year in the United States that is decisively lower than last year.

Now we still, as you know very well, have got a few years to go, but there is some progress there.

Look at the trade situation. Now everyone focuses, quite naturally, on the nominal amounts, all this great attention last week to the Japanese surplus in nominal terms. That is appropriate. But when we look at what is happening in real terms, in other words, abstracting from the so-called "J" curve effects, there are some encouraging signs, although not decisive. In our own case, if you look at the GNP accounts for the fourth quarter of last year and the first quarter of this year—of course they get revised five times—but you look at them as they are now, and you find that in real terms, our trade deficit in those two quarters combined has dropped by over $20 billion.

You look at Japan, and again, they have this big nominal increase in their trade surplus, but $15 odd billion of that was due to the fact that they benefited from lower oil prices, and all the rest of it was so-called "J" curve effects growing out of exchange rate changes.

In fact last year, Japan's trade surplus in volume terms declined rather sharply. Exports, in volume terms, were down more than 1 percent for the year, and this is astonishing: imports in Japan, in real terms, were up 12 percent.

To put it another way, on a GNP basis, in Japan, the change in their net export account had a drag effect on their GNP of 1.5 percentage points.

Now I cite those few statistics not because they are decisive. They are not. We have got a long way to go. But I cite them because I am not ready to accept the "doom and gloom" prognosis that says the only way we can get out of this is through regressive actions on both sides, and through contraction or recession, or both.

We have got to find a better way. I think we know, in general, what that better way is. The question is, will all of us, including us in the United States, have the courage and conviction to see it through?

ACTIONS IN BANKING AND SECURITIES NOT CONDONED

Senator DOMENICI. Well, let me just close by saying I hope you do not construe my analysis, which you generally agreed with, to mean that as we move through this rectification, or whatever the word is, of the imbalance, and cause the world to start growing more—which obviously has to happen—I do not want you to think that I condone the kinds of actions that perhaps are occurring in the banking and securities area.

You know, it is very interesting to me, that we fall down in one area and we start talking to ourselves about building back up our competitive capability in manufacturing, and we pride ourselves on becoming a major service country, and we pride ourselves—among

those services, the stock market, banking, and the like are supposedly excellent—and then we come along and find that you issue a couple licenses on the hope that they may reciprocate in some way.

I mean, I hope you understand and I hope they understand, that a Senator like this Senator is not saying, that because there is this huge macro problem, that we can sit by and watch the micro, the little pieces of it go all their way, as if incidental or irrelevant.

I mean, in an open society like ours, the Japanese ought to understand that they become enormously relevant. In the macro sense they may be tiny, but in the fever sense, of some kind of equity, and some kind of fear, they become very big, and I hope you understand that as you attempt to get some reciprocity for your actions that the chairman has cited already in his question.

Thank you very much, Mr. Chairman.

Chairman CHILES. Thank you, sir. We would like to put on Mr. Binney as soon as we can because we are going to have to go to the floor soon on the budget.

Did you have questions that you wanted to ask?

Senator GRASSLEY. Yes; I do, but is it going to cause any problem?

Chairman CHILES. Well, I hope Mr. Corrigan can keep his answers short, because we want to hear from Mr. Binney.

Senator GRASSLEY. You did not suggest you did not want any of the other members to come, so I came.

Chairman CHILES. Delighted.

JAPANESE DON'T FULLY CARRY THROUGH ON PROMISES

Senator GRASSLEY. Mr. Corrigan, one of the premises that I make quite frequently in debates on trade issues, particularly as it affects the Japanese, and it would be in regard to goods as opposed to financial services, but I am going to carry over this premise to a question to you about financial services.

And that premise is, that basically, there would be a much greater improvement in attitude between the United States and Japan, and a much greater improvement in our trade imbalance, if the Japanese would just carry through what they said that they would do at a certain period in time.

In other words, they say we are going to move from "x" to "y" but they move only part way from "x" to "y". Whereas, if they would go fully from "x" to "y" we would be in a much better position and we would have a much better attitude of the good-faith steps that the Japanese say they are going to take, that they do not take.

So then, in regard to that, I would use as a basis for my questions to you, some of the remarks you made in item number 4, the record of the past 6 months, starting on page 18, and not refer to any specific thing there, but just to say that you outlined there certain things that have happened over the last 6 months, and you refer to further things that need to be done in yen-dollar discussions between the U.S. Treasury and the Japanese authorities that are planned for the near future.

MANY COMMITMENTS HAVE BEEN MADE

Well, what I would like to have you relate for us is whether or not in the service area, financial, particularly, as opposed to goods, that there is a better, or worse, or the same bad track record of negotiations with the Japanese.

In other words, have they carried out what they said that they were going to carry out 1 year or 6 months ago?

Have they actually done that on the timetable that was laid out in that agreement, or are they running way behind, and are they not, in full faith doing what they said they were going to do? because I firmily believe they have not done this in goods.

Mr. CORRIGAN. I think, Mr. Senator, I can fairly say, from my perspective, that as a general matter, the track record in the financial area is, I think, better than it is on the good side.

In many, many instances, the commitments that have been made, whether it is to the Treasury, or to us in this particular area, in the 3 years, have been reasonably well adhered to.

Now, having said that, there are, without a doubt, instances and examples on which you can point to slippage. When that occurs, I try to find out why it occurs, and sometimes I am more satisfied than others as to why it occurred.

But it is certainly better, I think, than on the goods side, but perhaps not as good as it could be.

MARKET NOT OPEN ON 10-YEAR BONDS

Senator GRASSLEY. Well, as an example, you referred to their response to our demand that we be able to deal in their national debt, buy their bonds.

They made some progress, yes, in an area, but where most of their business is in the 10-year bonds, they have not really opened up their market.

Is that an example?

Mr. CORRIGAN. Well, again, they have made some strides there. From their perspective, the shares in the syndicate that they have granted to U.S. securities firms are roughly in line with the secondary market activity of those firms and their growth. But I would agree, that that is good, but not good enough.

Senator GRASSLEY. Well, would this be an area where they actually indicated to you in negotiations and consultations over the last year, that they would have made further progress, that they did not?

Mr. CORRIGAN. No; I cannot say that. I mean, I think they might have suspected that I might have hoped for more, as I expect there will be more, but there was no firm understanding that would be violated in any sense of the word. No.

BUREAUCRACY IS A PROBLEM

Senator GRASSLEY. To what extent do you see decisions made at the political level, among politicians in negotiations, being made in what we would consider good movement in our direction, and then seeing those so-called decisions frustrated by the actions later on of the bureaucracy, we will say, of the Finance Department, the Central Bank, et cetera?

Because this is a problem we have in the negotiations on the trade of goods.

Mr. CORRIGAN. Again, it can be a problem on the financial side as well.

Senator GRASSLEY. Is it a problem?

Mr. CORRIGAN. It is in some cases, yes. The bureaucracy—and I specifically mentioned that—the bureaucracy is a problem, and we have tried to deal with that, to some extent, Senator, by trying to move in the direction of getting our people better exposed to their counterparts in the Japanese bureacuracies.

Senator GRASSLEY. I am done with my questioning. I will stay.

Chairman CHILES. Thank you very much, Mr. Corrigan. We appreciate very much your testimony.

I am going to ask Mr. Binney to come up now, and if Congressman Schumer will come up and just sit with Mr. Binney. Again, we offer our apologies. We had no idea that we were going to be on the floor with the budget this morning, and we are supposed to lay that down at 10:30, so that constrains us.

Senator Grassley will try to stay, but I would like to hear some of Mr. Binney's statement, if I can, before we leave.

Senator GRASSLEY. Yes; would you announce to them that I cannot stay past 11:00.

Chairman CHILES. Well, our hearing will conclude around 11:00, so I think we will have time. I think, Congressman Schumer, you understand the dilemma that we find ourselves in.

Mr. SCHUMER. I perfectly do.

Chairman CHILES. Mr. Binney, I want to just thank you very much for being here as the senior vice president in Chase's international banking sector, and country manager for Japan. Your testimony is very vital to us. Your help has been very vital to this subcommittee. As I mentioned earlier, you have spoken on this subject on both sides of the Pacific, and we are delighted to have you here today to represent your institution, because we did find that many did back off from this hearing.

So you are the fellow "up front" at Chase, and we appreciate that very much, and we apologize, again, for our time constraints.

If you could brief your statement to me, it would be helpful. I would like to be able to hear that and I apologize again to Congressman Schumer, that we are going to have to jump up and leave Senator Grassley to preside.

Mr. SCHUMER. No problem.

Chairman CHILES. We appreciate, again, Congressman Schumer's continued interest in this subject. He has been one who has probably spoken out longer and louder as an advocate from the House side.

Mr. Binney.

STATEMENT OF ROBERT H. BINNEY, SENIOR VICE PRESIDENT, CHASE MANHATTAN BANK

Mr. BINNEY. Thank you very much, Mr. Chairman.

May I just be sure that my testimony will be part of the record.

Chairman CHILES. Your statement, in full, will be placed in the record and it is going to be very helpful to us.[1]

Mr. BINNEY. Thank you very much.

JAPAN PRESENTS FIERCELY COMPETITIVE MARKET

Maybe just by way of introduction to the other members of the committee, I should say that I have lived in Japan for 3½ years as part of a 16-year career with Chase, principally in our investment banking and merchant banking area, both in London and in Hong Kong.

But briefly, on Japan, I think the first thing to say is it is a fiercely competitive market. Nothing is given at all easily by any Japanese competitor.

It is a very large market, and therefore, even a small market share can be significant, but from the point of view of the foreign banks, over the last 10 years, it has been a singularly unprofitable market.

There are some 80 foreign banks in Japan, and, collectively, between us, we have 3 percent of the banking assets of the country, and about 1 percent of the banking profits of the country.

So you can see the kind of squeeze we are under from a market share perspective.

Chairman CHILES. Three percent of the assets and 1 percent of the profit?

Mr. BINNEY. That is right, and I assure you, it is not that we are not working pretty hard.

I think, second, on Japan, one should say that foreigners are always going to be at some kind of disadvantage. We are always going to be somewhat on the outside competing in this fearsome marketplace.

To some extent, I think we are making do with the scraps that are left behind, or some particular niche strategy where we have an advantage over the domestic indigenous competition.

There are clearly some huge cultural problems in doing business in Japan.

Let me, if I may, just briefly give you a little anecdote which I think illustrates the cultural difference somewhat. If you want to effect change in a business, whether it be in New York, in London, or in Hong Kong, you can bring your direct reports in on a Monday morning, explain to them that instead of doing A, B, C, in the future we are going to do X, Y, Z; and if you explain it properly and get people psyched up, you can probably get them leaving the room believers and going out and doing the new things.

If you try the same sort of tack in Japan, you will find all the Japanese in your staff will politely write down what you said and will understand you perfectly. They will say "hai" and then go back to their desks and continue doing precisely what they were doing before. No change at all would have taken place through that medium.

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[1] See p. 76.

LIBERALIZATION HAS TAKEN PLACE

If we look briefly at the liberalization that has taken place to date, it is my judgment that everything that the Japanese Ministry of Finance agreed to do in liberalizing the financial markets in Japan has taken place, either on schedule, or ahead of schedule.

These agreements were contained most notably in the May 1984 ad hoc committee report, which was the major item on the agenda, the U.S. Treasury and in a series of statements by the Japanese Ministry of Finance.

As a result of the liberalization, there has been some good news and some bad news for us in the financial marketplace in Japan.

First, on the good news side, we have seen a huge explosion in the foreign exchange market in Japan. Tokyo has now clearly overtaken Singapore as the major Asian foreign exchange center.

Recent Bank of England statistics suggest it is at least as large now as the New York foreign exchange market, and half the size of the London market, which is the world's largest.

Second, we have seen in just 18 months, the birth of an active Japanese government bond futures market. The futures market in Japan has grown dramatically, so it now has a larger turnover than the Chicago futures market on U.S. Government futures.

In other words, the growth and the depth of that market, the liquidity it provides, and the hedging it gives banks and securities companies, is dramatic, and is a major positive liberalization from our point of view.

Third, we have seen the Euro-yen market, principally in London, but also in other European centers, grow significantly. The yen now rivals, and in some cases supersedes the deutschemark as the world's second largest currency for international issues, both still well behind the dollar.

On the flip side, we have some not so good news. Japan has created a yen-denominated bankers' acceptance market which I can only describe as a monumental flop. There just has not been that much demand for yen-denominated BA's. The dollar BA market is very much the rule.

In addition, they introduced with great fanfare, last December, a Tokyo international banking facility which they call a Japan offshore market.

This market, in absolute terms, it has got considerably in excess of $100 billion now in total volume, but it has not been a success because the net new deposits that are being created—as distinct from bookkeeping transactons from domestic Tokyo branches into the offshore market—have been insignificant.

In other words, the net new demand for business that has been created to date has been very small, indeed.

DEREGULATION OF DEPOSIT INTEREST RATES

Another major item is deposit interest rate deregulation. Although there has been some considerable progress in relaxing rates, we still have a case where 70 percent of deposits are regulated by Government edict, either officially or by so-called "administrative guidance."

By administrative guidance, I am talking about unofficial bureaucratic supervision of what takes place.

The bureaucrats have enormous control and say in interpretation, and therefore, we find ourselves at a considerable disadvantage in competing for deposits from some of the cash-rich institutions in Japan, many of which are government-controlled or in the government sector.

On the other hand, there are occasions where administrative guidance can be particularly beneficial. I can give you one example from my own experience. Shortly after I arrived in Japan, I got a phone call from the Ministry of Finance to say that they were on the point of announcing a liberalization measure, and they wanted a number of financial institutions to benefit from this, and would I kindly get my application in "toute suite" because the following Wednesday they were going to announce the list, and if we got on with it, we could be part of the list.

Their concept was very much that they wanted the leading institutions to go through on an equal basis, that the leader would not get any particular advantage, and they wanted to be sure that we were a part of that group, and therefore they told me, unofficially, get on with it, and you will officially be blessed. So it can work both ways, although on balance, I am bound to tell you, administrative guidance is more of a nuisance than a blessing.

"LAUNDRY LIST" OF REMAINING BARRIERS

I have outlined in my testimony some eight remaining barriers which I would like to see lifted. It is a "laundry list" approach, I appreciate, but let me just briefly go through them, in no particular order.

First, on the subject of domestic yen funding, we have got to get rid of administrative guidance on the brokerage companies as well as the collateral requirements that still bedevils the short-term yen money markets.

Second, we need to eliminate all the remaining interest rate controls that exist. Seventy percent of deposits are still controlled.

Third, we have got to get the offshore market in Tokyo, in my judgment, to be truly free, and truly subject to supply-demand factors, and part of that would involve eliminating some of the crazy tax arrangements that exist right now.

But I also think that action should be taken to address something that should interest this committeee, and other committees in Congress. Specifically, I would like to see the elimination of the withholding tax on interest payments between Japan and the United States as part of a general mechanism to ease investment by Japanese in this country and by Americans in Japan.

Forth, with respect to short-term money-market liberalization, one of the other items I would like to see is the development of a yen commercial paper market. To date there is no commercial paper market in Japan, although we are expecting one to be formally announced in the relatively near future.

Fifth, I have mentioned the Japanese Government bond futures market in Japan. They clearly need other futures markets badly in Japan. Otherwise, that business is going to be done offshore in

Singapore or Sydney, and the sooner they patriate that back to Japan, I think the better it will be for a healthy economy in Tokyo.

Sixth, and we have heard mention of this also, the Tokyo stock exchange. There are only six foreign members on that exchange right now. This is clearly a ludicrous situation, and we need to speed up the seats for foreigners, both for the securities companies that are European as well as those that are American-owned and controlled, and that needs to be done in a large number, probably on the order of 25 to 30 new seats for foreigners in very short order.

Seven, being basically an investment banker, albeit working for a commercial bank, I would like to see abolition of article 65, which is the Japanese version of Glass-Steagall, and we can go into all kinds of reasons why I think that makes eminent sense.

STANDARDIZED CAPITAL RATIOS NEEDED

And last—and this was also mentioned by Mr. Corrigan earlier—on capital ratios for banks, I am very sympathetic to the need for some standardized capital ratios, and particularly the need to bring into the net of capital ratios off-balance-sheet items such as SWAPs, standby letters of credit, and other off-balance-sheet items.

But what concerns me most strongly about this is that I do not want to see those ratios brought in to affect U.S. banks until the same ratios affect Japanese banks.

I feel anyway that we are competing in Japan effectively with one hand tied behind our back, given the cultural problems of a foreigner in that country.

I think for us also to have to compete against big and very competitive Japanese institutions with our foot also tied because of capital ratios would impact us more seriously than they impact Japanese banks. This is plainly unfair and should not be allowed.

TAX TREATMENT AND RESERVE REQUIREMENTS

Last, on the question of international competitiveness, I think that other issues that the committee needs to consider are tax treatment and reserve requirements. We need to get some more demonstrable equality in tax treatments between banks in Japan and this country and reserve requirements need to be brought into line.

If you ask me to prioritize these things, from my perspective, the four that I would say are the most important issues I would like to see pressure brought to bear on in the very near future, would firstly be the Tokyo stock exchange.

There are only six foreigners right now that are members, four of them are American companies. Those are Goldman Sachs, Merrill Lynch, Morgan Stanley, and Vickers-D'Acosta which is a subsidiary of Citibank.

Interestingly, Salomon Brothers and First Boston are two names that are not on that list, and obviously we, and a number of others, very much want to be on that list in conjunction with a goodly number of British, French, German, Swiss, and other foreign companies.

I think the excuse that is being given right now to delay and maybe prohibit us getting a seat on the Tokyo stock exchange is principally one of space.

I frankly find the issue of space to be a spurious argument for a technologically very advanced country. They must be able to find ways. Where there is a will, there is a way.

My second priority will be on capital ratios. I would implore this committee and others that are interested in making sure that our off-balance-sheet items are properly accounted for, to consider whether the same considerations apply to Japanese institutions at the same time, and to ensure that we do not find ourselves at an unfair advantage.

Third, on domestic yen funding, I would like to see more liberalization, elimination of the collateral requirements, less administrative guidance, and a market for yen interest rates which is more subject to supply-demand and less to administrative edict.

And fourth, the issue of withholding tax on interest payments that I referred to earlier on interest payments from Japan to this country or vice-versa.

I was asked to make a brief statement about congressional actions, as to what I would or would not recommend that you do.

INCREASE PRESSURE TO NEGOTIATE FAIRLY BUT TOUGHLY

I think that the foremost thing I would recommend is that you increase the pressure on the administration and particularly on the Treasury to negotiate fairly but toughly with the Japanese Ministry of Finance.

I think it is most important that they be given steel, that they have a strong backbone, and maintain absolute U.S. pressure on Japanese to open up.

I think the most successful examples that we have seen of good liberalization measures in Japan have been the direct result of U.S. Government pressure. It does not have to be legislative pressure. The threat of legislation might get their attention, but is strong administrative pressure that gets results.

One example that I think is salient here is the pressure applied to the German Government and the British Government, which both said that they do not accept the distinction between securities companies and commercial banks. Because Glass-Steagall type legislation does not exist in Europe. The governments argued that the major German and British banks should be allowed access to the securities market in Japan. And it was only as a result of direct German, and then British and Swiss Government pressure, that the Japanese Ministry of Finance gave in on that issue, which has directly resulted in our ability—and now, very shortly, the ability of four other major New York banks—to open securities companies in Japan.

That is the sort of pressure that I would strongly recommend this committee bring to bear.

Mr. Chairman, Mr. Senator, thank you very much.

Senator GRASSLEY. Thank you, Mr. Binney.

[The prepared statement of Mr. Binney follows:]

Testimony of

ROBERT H. BINNEY

Senior Vice President

CHASE MANHATTAN BANK

Before The

BUDGET COMMITTEE

UNITED STATES SENATE

MAY 6, 1987

I am Robert Binney, Senior Vice President in Chase Manhattan Bank's International Banking Sector and Country Manager for Japan. I very much appreciate the opportunity to participate in this hearing on the liberalization of the Japanese financial markets.

I strongly believe that the need for open markets in services trade is just as significant as the need for open markets for manufactured goods, although the latter tends to attract more public attention. The Committee is to be commended for addressing this most important issue as it affects U.S. financial service providers.

Any discussion ot the Japanese financial system would be meaningless if we do not first consider two powerful and irresistible forces at work in the financial services arena today.

I am referring to the increasing securitization of debt --

which has radically altered the nature of commercial banking -- and the increasing internationalization of the world's capital markets.

The Changing Nature of Commercial Banking

Commercial banks are in the business of supplying money, but this business has changed dramatically since Congress passed the Glass-Steagall Act in 1933. Without doubt the most significant change we have seen in recent years is the move away from bank intermediation to bank disintermediation.

Today, many of the most creditworthy borrowers do not have to shop at banks for working capital; they can raise money in the credit markets directly. The commercial loan, once the central tool of corporate finance, now stands beside a growing array of alternative financial products. In effect, these firms have eliminated the middleman.

Whether in the United States, in Asia or in Europe, companies are turning in increasing numbers towards securitized debt as an alternative to bank loans to finance their businesses.

Last year, for example, of the total of $318 billion raised in the London markets, almost $290 billion represented securitized debt in one form or another. In the United States, the shift away from bank loans is proceeding so quickly that U.S. banks have lost considerable market share to nonbank

competitors who are not subject to the same constraints. In absolute terms, the U.S. commercial paper market has grown from $60 billion in 1976 to $339 billion at year-end 1986. More significantly, the ratio of commercial paper to New York City money center banks' commercial loans jumped from 30 percent in 1973 to 138 percent in 1985.

As a result, banks are increasingly shifting their attention from lending towards trading and capital markets activities.

The Internationalization of the Capital Markets

When we consider the development of Japan's capital market, it is also important to look at the issue, not in isolation, but rather in the context of the development of a global financial marketplace. This globalization has been made possible by new technological developments and by innovative financial products -- many of them bank-loan substitutes -- that take advantage of the new technology.

The pace of change in the financial markets has gathered great momentum. The sheer number of transactions executed daily, their total currency value, and the speed at which they are completed continue to increase at a rapid clip. In a world of advanced information technology, distance is no longer an issue and a transaction will naturally gravitate to the market that offers the greatest efficiency. For instance, because of

Article 65, Japanese banks issue Japanese corporate debt to Japanese investors by way of London, not Tokyo. The same is true of U.S. banks' relationship with U.S. companies and U.S. investors.

To the extent that a national capital market -- Japan's or any other country's -- is not fully open and fully integrated into the international capital market, inefficiencies are created, which raise costs for those seeking capital and for those supplying it.

It is from this perspective that I would like to share some thoughts on how Japan might accelerate the trend toward liberalization. In doing so, I will be focusing on similarities and differences between the U.S. and Japanese banking systems and on the general benefit to <u>both</u> countries, and to the world economy, of expanding market access. The fact that the U.S. to a large extent, and the U.K. to an even greater extent, have traveled further down the path of liberalization than Japan may mean that certain lessons could be learned from their experience.

Some Progress Has Been Made

Before suggesting ways in which Japan might move toward a more open financial services system, it is necessary to point out that some noteworthy progress has already been made.

The Ministry of Finance and the Bank of Tokyo are to be congratulated for implementing several important deregulatory changes. For instance, Japan has somewhat warily begun the process of deregulating deposit interest rates, starting, as the U.S. did, with large denomination time deposits. In the last two years, the percentage of Japanese bank deposits subject to interest rate ceilings decreased from about 90 percent to about 80 percent. In addition, the creation of new Euroyen instruments has been authorized and a number of foreign banks have been permitted to enter the trust banking business and to deal in Japanese public securities. These and other changes are very positive developments and should not be overlooked when considering Japan's commitment to financial change. However, it remains true that the pace of deregulation has been guarded and that many additional steps must be taken.

Foreign banks continue to find that penetration of Japanese markets does not come easy. As the Treasury Department's 1986 report on the treatment or banks abroad confirms, foreign banks still have problems funding themselves in domestic yen, which makes Japan an "uncongenial lending market for foreign banks." In addition, they are severely restricted in their ability to bring to the Japanese market products that have been successfully employed in the Euromarket.

The Benefits of Further Liberalization

Substantial benefits would accrue not only to foreign banks but also to Japan itself from expanded market access.

Of particular note is a recent study by the Federal Reserve Bank of New York which showed slow employment growth overall in the U.S. financial services industry, largely attributable to the automation of retail banking services. However, the report cites New York City as an exception to this trend, noting that the city will benefit from the increasing amount of international business conducted there. The report also singled out for praise the efforts of local authorities to lower the tax burden on banks so that they can compete more effectively with foreign banks.

Consider as well London's emergence as Europe's financial center. With the development of the Euromarket, the number of foreign banks in London quickly rose to 163 by the early 1970s and to over 400 by the end of 1985. This influx has had a significant impact on the U.K. economy, producing over 43,000 jobs, attracting capital to the U.K., and generating invisible earnings of $2.9 billion.

In October 1986, London ended fixed commissions and allowed securities firms to combine brokerage and market-making roles. This "Big Bang" has resulted in a new influx of financial business, mushrooming job totals, and more attractive pricing for firms in the capital markets.

Because of its liberal regulatory environment, London will likely continue to develop at a faster rate than both New York and Tokyo, where outdated regulations (especially Glass-Steagall and Article 65) hamper the ability of local financial institutions to meet the needs of corporate finance officers and investors.

If Tokyo is to become the third link in an international capital markets triangle along with New York and London, it will need to create an environment that is more hospitable toward market innovation than currently exists.

The yen's importance as an international currency and Japan's position as a major trading nation do not assure that it will play the role of a principal financial center got the Asia-Pacific region. Despite West Germany's superior economic performance over the last decade, and the importance of the Deutschemark, it was London and not Frankfurt that developed into Europe's leading financial center. Similarly, a strong challenge to Japan's position is being mounted by Singapore, Hong Kong and Sydney.

The Euromarket's lesson for Tokyo, or for any other locality, is clear: it is that failure to adapt its regulatory environment to the changing needs of the marketplace will lead to systematic instability and to a loss of business to overseas financial centers, resulting in lost capital, lost jobs and lost income.

Recommendations

I would like to suggest seven steps Tokyo might take to create a more efficient and equitable financial services system:

(1) Relaxation of Bank of Japan "administrative guidance" on Tanshi brokerage companies;
(2) Complete removal of controls on deposit interest rates;
(3) Increased liberalization of its International Banking Facilities;
(4) Deregulation of its short-term money markets;
(5) Development of a comprehensive futures market;
(6) Further opening up of the Tokyo Stock Exchange to foreign membership and the removal of fixed commissions;
(7) Repeal of Article 65 restrictions.

Relaxation of "Guidance" on Tanshi Brokerage Companies

An important aspect of Japan's system of interest rate controls is the Bank of Japan's "administrative guidance" via the system of Tanshi brokerage companies. In spite of the huge supply of yen funds in Japan, foreign banks are virtually unable to tap this source of funds directly. Instead, Bank of

Japan administrative guidance requires that they go through middlemen in the form of the six Tanshi brokers. As foreign banks do not have the retail deposit base of the domestic Japanese commercial banks, this requirement represents a severe competitive disadvantage.

Not only must we pay domestic banks a margin on funds raised in the interbank market, which in part compensates them for the cost of their branch networks, but we also pay an additional margin of something on the order of one sixteenth of one percent to the Tanshi company for its intermediation in this fund raising activity.

I do not believe this situation to be in the best interests of the Japanese depositors who supply these funds, the Japanese institutions that place them, or the foreign banks that gather them. Relaxation of such guidance is important both to the development of a healthy international capital market and to providing an even playing field on which Japanese and foreign banks can compete.

A major instrument in the short-term money market is the Bills Discount market. Unfortunately, the collateral requirements for this market are anachronistic and, in my opinion, should rapidly be scrapped. Chase is a better credit risk than most of the companies whose collateral we have to provide in order to obtain Bills Discount funding. Additionally, given our generally superior credit, there should be no need for us to pay any premium in the recently deregulated non-collateralized Bills Discount market.

Currently, the domestic yen money market is 50 basis points cheaper than the equivalent Euroyen market. Accordingly, we would prefer to fund ourselves with more of the cheaper domestic yen deposits, but given the effects of Bank of Japan administrative guidance, it is necessary for us to go offshore for the majority of our yen funding requirements. We believe that such distortions between the domestic and offshore yen markets are inappropriate and that they ill-serve Tokyo's ambition to become a major financial center. Clearly, in a free market environment, there should be little or no arbitrage opportunity between domestic and overseas sources of funds.

Deregulation of Deposit Interest Rates

There are a number of striking similarities between the development of financial markets in the U.S. and in Japan. These similarities affect both sides of the industry's balance sheet, but they begin with the liabilities side.

For decades, American banks were subject to vigorous restrictions on the deposit interest rates they could offer. The rationale given for these restrictions was that unregulated competition over rates was a major factor in causing the Great Depression of the 1930s. Although scholars have said for years that this claim is without foundation, interest rate controls

remained in effect until market developments forced their elimination.

In the 1970s, U.S. banks became the victim of disintermediation as nonbanking companies using modern computer technology showed they could market deposit-like products without the need of a bank charter or bank branches which were costly to maintain. Regulation Q, which placed a cap on deposit interest rates, was a major contributor to the growth of the unregulated Euromarket and was also easily circumvented by retail customers who diverted funds to Money Market Mutual Funds.

By 1982, the total in these funds equaled the total of all bank checking accounts. Hence, a regulation designed to protect banks from instability became an instrument of instability. Only then did Congress grant U.S. commercial banks the authority to phase in market interest rates and offer NOW accounts -- in effect, interest-bearing checking accounts. This process, which has enabled banks to retrieve some of their lost deposit pool, was successfully completed last year. Even so, competition with mutual funds and with the cash management accounts offered by U.S. securities firms remains fierce.

Clearly, interest rate consciousness is a factor in Japan as well, as four securities companies compete for Japan's domestic savings by offering customers higher returns than are currently available on bank deposits. Japanese banks facing competition from investment trusts and government bond funds

are in a position similar to the one U.S. banks faced a few years ago.

I also believe that concerns voiced about possible disruptions will prove to be exaggerated. As market forces come into play, any such disruptions are likely to be minimal and short-lived. One such fear that was voiced when the U.S. started its program of deposit interest deregulation was that smaller banks would suffer and similar concerns have been expressed here. At the end of the day, that concern appears to have been largely unfounded. Well-managed banks facing higher costs of funds have remained competitive. Artificially low costs of funds only protect poor bank managers, creating market distortions and diseconomies.

The Offshore Market

While the establishment of the Japanese offshore market is a very positive signal of Japan's intention to liberalize its capital market, it has not been a marked success. The reason for this is that no genuine offshore deposit base has developed.

One step commonly advocated is the removal of the stamp duty. This action would bring the Japanese offshore market closer to New York's IBFs. But I would recommend going one step further, and have Japan seek to emulate the even freer environment of London.

For example, the Japanese authorities could permit the establishment of IBFs or Offshore Banking Units which would be treated as Japanese corporations free of all taxes, provided that they were funded by offshore deposits and their funds were invested offshore. Ownership could be limited to offshore parties who are introducing foreign business to Japan. In this way Japan would attract a share of business currently being transacted elsewhere.

According similarly structured branches of foreign corporations like treatment would allow use of the parent's larger economic base and its tax treaty network as well.

Another point I would like to make in relation to the Japanese offshore market involves withholding taxes. The United States, the United Kingdom, West Germany, along with several other major developed countries, currently impose no withholding tax on foreign investors in each other's countries. It is time that the United States and Japan sought the renegotiation of their bilateral tax treaty to entirely eliminate the withholding tax on interest between the two countries.

When the U.S. eliminated its 30 percent withholding tax in 1984, the move came with the support of the Treasury Department despite concerns voiced in some quarters about the possible loss of tax revenues. Treasury took the position that markets function best when issuers have equal and direct access to the available pool of capital. Fears about increased tax evasion

by U.S. citizens have been addressed by developing procedures aimed at ensuring that bearer bonds issued by U.S. corporations are targeted only to foreign investors. In addition, strict reporting requirements are applied to any such obligations finding their way back to the U.S.

Deregulation of the Short-Term Money Markets

We have already seen some progress in this area. Regulations on the conversion of foreign funds into yen have been ended and restrictions that previously existed on Euroyen transactions by domestic banks have been removed. In addition, allowable denominations of Money Market Certificates have been steadily reduced, a bankers acceptance market has been introduced, and restrictions on CDs have been eased.

However, commercial paper -- probably the fastest-growing instrument in the international capital markets -- is barely in its infancy in Japan. There is at present no yen commercial paper market even though Japanese banks and brokers are allowed to deal in foreign commercial paper, even though a number of large Japanese companies have become issuers of commercial paper both in Europe and the United States, and even though Japanese investors have bought foreign commercial paper in Japan or the paper of Japanese companies abroad.

Development of a Comprehensive Futures Market

Today, only one type of futures contract -- in Japanese government bonds -- is available in Japan, although a Stock Futures 50 Index will be introduced in Osaka in June. This compares with 23 futures instruments in New York, nearly 50 in Chicago, and 11 futures and six options contracts in London. In February of this year alone, 822,000 contracts were written in London, representing a turnover in excess of $250 billion.

An active futures market is fundamental to a healthy international financial market. For example, large securities firms such as Salomon Bros. regularly trade in futures as part of their market-making activities in U.S. government securities and in corporate debt instruments. The level of securities holdings maintained by a firm the size of Salomon Bros. would expose it to serious interest rate risk if it could not protect against losses by selling short in the futures market. In recent years, U.S. banks have also become active as futures market brokers for nonfinancial corporations seeking to hedge their exposures.

Opening Up the Tokyo Stock Exchange

The opening up of the Tokyo Stock Exchange to foreign membership and the removal of fixed commissions are essential

elements in building Tokyo's position as the third center of the international capital markets triangle.

In both London and New York we have seen the abolition of controls on commissions as well as the opening up of those markets to foreign firms. By contrast, the Tokyo Stock Exchange has admitted only six foreign member firms -- thereby ensuring that competitors are kept at arms length -- and it has reaffirmed its stand on fixed commissions (members also earn 27 percent of nonmember commissions). These policies protect Exchange members from real competition and so cannot be viewed as being in the best interests of either the equity issuer or the investing public.

This situation must change if Tokyo is to develop as an international financial market. Not only will we need to see the abolition of fixed commissions and greater foreign participation but it is also important that more foreign stocks be quoted on the Exchange. Today 55 foreign stocks are traded on the Tokyo Stock Exchange, only slightly less than New York's 57, but considerably less that the over 500 foreign stocks listed and traded in London.

I have already alluded to the fact that as the world's financial markets become increasingly global there will ultimately come a point when any transaction may be made at any hour, in any currency, and in any place, almost instantaneously.

Today, it is less expensive to acquire a Japanese stock listed on either the London or New York exchanges than it is to

buy it on the Tokyo Stock Exchange. Such a situation does not serve either the Japanese company nor the Japanese investor well.

Repeal of Article 65 Restrictions

I have already noted how the U.S. and Japanese banking systems have been similarly treated as regards deposit interest rates. But the similarity does not end there. Hand in hand with deposit rate regulation has been product regulation, or, more precisely, the lack thereof. The Glass-Steagall Act imposes strict limits on the securities activities of U.S. banks, while Japan's Article 65 plays a similar role in drawing a firm line between commercial banking and investment banking.

The simple fact is that these laws are anachronistic. That this is so is readily apparent from the steadily declining market share experienced by U.S. banks. Between 1946 and 1985, U.S. banks' share of all assets held by U.S. financial institutions dropped from 57 percent to 33 percent. First commercial paper, and now asset-backed securities, are taking over where once the commercial bank loan ruled.

Because banks may not underwrite corporate securities under today's anachronistic system, they face the danger of becoming merely agents for the securities industry, originating loans that are later sold to securities firms and then repackaged as securities.

Scholars and banking regulators are moving quickly toward a consensus on how to restructure the banking industry so that it is free to compete in this huge market while at the same time ensuring the stability of the system. Unfortunately, Congress is moving much more slowly in this direction. In fact, the Senate-passed moratorium on new bank powers would be a large step backward. Although intended to freeze the current situation until Congress takes a closer look at the issue, the bill would effectively lock in competitive advantages now enjoyed by nonbank companies. They could then proceed to build on these advantages while banks remain hamstrung by Glass-Steagall.

In the U.S., as in Japan, the great irony is that domestic banks are permitted to engage in these prohibited securities activities abroad -- and do so profitably and safely -- while they are denied these powers at home.

Once again, as with deposit rate ceilings, a policy designed to protect banks actually poses a threat to their continued stability. Ensuring stability is universally acknowledged to be the rationale for much of bank regulation. However, opponents of deregulation seem not to understand that stability is threatened to the extent that bank earnings are threatened and that bank earnings are threatened to the extent that competitive equity among banks and other suppliers of capital is lacking. New sources of revenue from a broadened activity base are necessary to ensure bank soundness.

Failure to relieve U.S. and Japanese banks from the restrictions imposed by Glass-Steagall and Article 65 respectively means that U.S. and Japanese companies face higher capital formation costs than they would if bank product deregulation was a reality. Product deregulation could be expected to reduce costs by increasing competition in the highly concentrated investment banking industry.

The Competitive Position of U.S. Banks

It should be kept in mind, however, that Japanese banks would remain at a distinct competitive advantage vis a vis U.S. banks even if both countries instituted complete product deregulation and allowed unrestricted market entry. This is because of the extremely high savings rate of Japanese consumers, the prevailing cheapness of their retail deposits, and the generally lighter burden their bank regulators impose, especially with regard to the cost of meeting bank capital requirements.

As I indicated above, it is vitally important to view the issue of Japanese market access in the more comprehensive context of the international capital market. With this understood, it is fair to ask -- it must be asked -- what other factors play a role in determining whether U.S. banks can compete effectively in world markets.

In recent years, U.S. banks have lost considerable market standing worldwide:

- o Ranked by deposits:
  - -- The U.S. had only one of the top ten banks at year-end 1985 and two in the top 25 compared with 1956, when the U.S. had five of the top ten and 16 of the top 25;
  - -- By comparison, Japan had the top four banks in the world at year-end 1985 and seven of the top ten.
- o Ranked by market capitalization (probably the best measure of corporate power since it reflects the market's valuation of a company's usable future resources):
  - -- Of the top 100 companies in the world, only one US bank makes the list, at number 97;
  - -- Of the top 50 banking and securities companies operating in the international capital markets, only five are banking companies, at numbers 27, 29, 45, 49 and 50.
- o A recent BIS report shows Japanese banks increased their share of international lending from 23.2 percent in 1984 to 31.6 percent in 1986 while U.S. banks' share dropped from 26.3 percent to 18.6 percent over the same period.

Clearly, a great many variables are involved in determining

world rankings. Government-imposed costs -- including reserve requirements (which Japanese banks do not have), tax treatment, and capital ratio minimums -- are among the most important factors.

A noted banking analyst, Sanford Rose, recently calculated that for banks to earn a reasonable 25 percent to 30 percent pre-tax return, meeting current legal capital minimums requires a 150 basis point pre-tax spread. Adding in operating expenses, idle reserves and other cost factors raises this to 250 basis points. In a Euromarket characterized by thin margins as low as 6.25 basis points, this regulatory burden translates into higher costs for U.S. bank products, less competitiveness, and consequent loss of market share.

The risk-based capital proposal jointly issued recently by the Federal Reserve Board and the Bank of England is an honorable attempt to recognize that different bank assets carry different risks and so should require different levels of capital backing. For the first time, banks would have to hold capital against such off-balance-sheet items as standby letters of credit and interest rate and currency swaps. However, I am concerned that this attempt to rationalize and harmonize capital policies could put U.S. banks at a competitive disadvantage relative to U.S. investment banks and Japanese and West German commercial banks not subject to such a requirement.

In conclusion, I would like to emphasize that the issue of market access, while an important one, is intimately connected with the issue of international competitive equity. In considering what actions might be appropriate to more fully open the Japanese market to U.S. banks, the total picture of international competition must be kept clearly in mind. Reciprocity is not enough to ensure competitive equity if U.S. banks must labor under the weight of other, no less taxing, disadvantages.

Senator GRASSLEY. Congressman Schumer.

STATEMENT OF HON. CHARLES SCHUMER, A U.S. CONGRESSMAN FROM THE STATE OF NEW YORK

Mr. SCHUMER. Thank you very much, and I appreciate the committee having me here. I understand that we got together at the last minute, and so I do not have prepared written remarks.

What I would like to submit for the record, and I will try to be brief in my comments, is a letter that I sent to Chairman St Germain reporting on the trip that I recently took to Japan to explore the financial—services situation.

Senator GRASSLEY. Without objection, that will be a part of the record.[1]

Mr. SCHUMER. I thank you, and I thank the committee.

I would just like to make a couple of points in reference to what has happened.

EXPANSION SLOW IN JAPAN

I would agree with Mr. Corrigan that some progress has been made, but I think you look at the scale, and let's say a hundred would be the Japanese markets as completely open to us as our markets are to them. Zero would be them completely closed.

We may have gone from a 10 to a 20 in the last year. I would not feel terrible about that if the Japanese firms in the United States were doing the same, were expanding at a slow, tortoise-like rate.

But Japanese banks and Japanese securities firms here in the United States are expanding as rapidly as possible. So all the barriers that seem to be in the way of American firms growing in Japan are not occurring here.

And I think one of the weaknesses in Mr. Corrigan—a man I admire and worked closely with—one of the weaknesses in his argument is very simply that expansion is occurring at different rates on different sides of the Pacific.

This is not a slow mutual process. It is slow and mutual for American firms, and quick and unilateral for Japanese firms here in the United States.

The second argument that I would make is that Mr. Corrigan talks about how a lot of our problems are domestic, and I certainly agree with that on trade issues. I have been labeled a free trader and I am not ashamed of that. I voted against the Gephardt amendment on the floor of the House the other day.

AMERICAN FINANCIAL SERVICES ARE SUPERIOR

But there is a distinction here, and the distinction is not only that free trade has to be at both ends of the Pacific, but there is a different distinction.

Our financial services, those that Mr. Binney, those that American banks and securities firms offer, are as good as any in the world.

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[1] See page 101.

This is not a case where a Honda is better than a Chevrolet, or Nippon Steel puts out a cheaper and better product than U.S. Steel.

In fact most independent people who look at the products offered by American banks and securities firms, compared to Japanese banks and securities firms, are almost unanimous in agreeing that our products are superior.

Now it is true that Japan has the money. Their savings rate is much better than ours, and that is to our detriment and their credit.

But if the markets were working the way the Secretary outlines, then it should be the firm that provides the best service that handles the money.

It should not simply be, because the money originates in Japan, the Japanese firms must handle them, and in that way, too, the markets are different.

I would say to my friend, the good Senator from Iowa, that the analogy to agriculture is much closer in financial services and the analogy to auto, steel, and other things is not close at all.

JAPANESE ARE SELLING FINANCIAL SERVICES

And there is even one difference between agriculture and financial services. The Japanese are not trying to sell their agricultural products here. They are selling their financial services.

In fact I believe that if the pace of progress continues to be as slow as it is today, that American and financial services firms will clearly be in a secondary position in 5 years, a position they are not in now.

Conversely, I believe that if Japanese markets were opened up quickly, then American firms would remain—perhaps sharing it with Japanese—but remain in a primary position.

Now to allow the progress to occur, in my opinion, at as slow a rate as it has, and being in Japan you can see why—the Japanese society, politically, is in fact more tied in a knot than we are. They just cannot do it.

Five little banks, if they do not want something done, can block things from happening in the LDP, and therefore, in the government.

That is not quite true here, although maybe we come close to it. And so you do not have free actors. There are people on the Japanese scene who wish to open up Japanese players, but they cannot, and the bottom line reason that I think legislation works better, in fact, than talking—if the legislation is narrowly and carefully drawn, as I believe the proposal in the House bill is—is that it changes the playing field.

We can talk from today until tomorrow, but unless there is some real incentive for Japanese to open up, it will not, because the political forces and their equilibrium dictates that it does not open up.

And yet, if we change the playing field a little bit, and again do it carefully, and do it in the pure framework of reciprocity, not protectionism, we can force them to open up. In fact what we are

doing is giving those forces in Japan that want to open up a weapon.

They go to the Ministry of Finance and they say look—before they just say you ought to do it because it is right. Now they can say, look, if you do not do it, we have certain problems that we did not have before.

So I do not think there should be wholesale legislation across the board, and I certainly do not think it should be protectionist, but I would ask the committee to examine the progress that has been made since my legislation was introduced on both seats on the stock exchange which, as Mr. Binney said, is pure subterfuge.

We visited the stock exchange. Each booth was 15 square feet. We told the Japanese that we could not believe that 150 square feet in a huge room was going to stand in the way of good relationships between us.

But getting to my point, if you look at the progress that has occurred since the legislation was introduced, I would argue that it is much greater in the areas that we have tried than it had been any time up to that.

And I would also argue it is not enough for Mr. Corrigan to argue, that from 1 percent to 5 percent, which was a recent change, in Government securities markets, is something to cheer about. That is wrongheaded, in my opinion, particularly when, again, we have a free market here and we have no such constraints here.

CONSIDER CAREFULLY CRAFTED, NARROWLY DRAWN LEGISLATION

So I would urge the committee to consider carefully crafted, narrowly drawn legislation, that is purely reciprocal, that says to the Japanese the rate you expand in the United States is going to be equivalent to the rate we expand in Japan. Your finger is on the dial.

If things expand quickly in Japan, you can continue to expand quickly here, but if not, you cannot. That that will produce the quickest and best results. And once more I would remind the committee that we do not have 10 or 15 years to do this.

The future of the American financial industry, which they are afraid to say, Senator, as the chairman of this committee noted, because they are all playing for the "crumbs" that the Japanese might indeed throw—the "scraps" as Mr. Binney said. So they cannot say it, but I can. If we do not do something quickly in the next 3 to 5 years, I believe that we will be doing our country and its financial services industry, now one of the centers of job creation, a major disservice.

I thank the committee.

Senator GRASSLEY. Thank you, Congressman.

[The letter submitted by Mr. Schumer follows:]

CHARLES E. SCHUMER
10TH DISTRICT, NEW YORK

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April 24, 1987

The Honorable Fernand St Germain
Chairman
Committee on Banking, Finance and
Urban Affairs
United States House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

Because of our mutual interest in the area of international trade and financial services, I want to provide you with details of an important series of meetings a Congressional delegation of your colleagues held in Japan during the recent spring recess. This delegation, including myself, Senator Jake Garn (R-Utah), and Congressmen Bruce Morrison (D-Conn.) and George Miller (D-Cal.), conducted a series of thirty meetings with top government and business leaders concerning problems in the expanding banking, securities and financial services trade between our two nations.

These talks were informative and, I believe, productive in highlighting some of the obstacles we face in the ever expanding globalization of the world financial marketplace. The purpose of the trip was to examine the treatment of U.S. financial institutions operating in Japan, especially in contrast to the treatment of Japanese firms operating in the United States. It is the view of all four members of the delegation that trade in financial services must be conducted on a fair and equitable basis and must not be obstructed by laws or practices which restrict safe and sound competition.

In order to share with you some of the areas of mutual concern and the results of our meetings, I have prepared the following synopsis of the issues and the trip's itinerary.

Itinerary April 12 - 18

Meetings attended by Senator Garn and Representatives Schumer, Morrison and Miller were held with the following:

Prime Minister Nakasone
U.S. Ambassador Mike Mansfield
Finance Minister Miyazawa
Foreign Minister Kuranari

Bank of Japan Governor Sumita
Labor Democratic Party Secretary General Takeshita and party members
Members of Liberal Democratic Party
Presidents of Nomura, Daiwa, Nikko & Yamaichi Securities
Officers of Industrial Bank of Japan
Officers of Sumitomo Bank
Officers of Yasuda Trust & Banking Corp.
Officers of Long Term Credit Bank of Japan
Executives of Tokyo Stock Exchange
Executives of Osaka Stock Exchange
Federation of Bankers' Association of Japan
Bankers' Association of Osaka
Officers of Mitsui Bank
Officers of Dai-Ichi Kango Bank
Officers of Bank of Tokyo
Executives of Keidanran (Federation of Economic Organizations)
Securities Dealers Association of Japan
Representatives of U.S. Securities Firms in Japan
Representatives of U.S. Banks in Japan

Issues in the Securities Industry

Disparities in the treatment of U.S. and Japanese securities firms in their respective countries and abroad have been highlighted recently by House Banking Committee adoption of an amendment to H.R. 3 -- the Omnibus Trade Bill -- which would require reciprocity in the government securities market between the U.S. and Japan. However, there are a number of additional problems in fair access to the securities market in Japan.

1. Open Competition in the Japanese Government Securities Market. Currently, the purchase of long-term Japanese government bond offerings is strictly allocated among banking (76%) and securities firms (24%). Additionally, foreign securities firms have been also limited in the amount of each bond offering they are allowed access to. In 1986, foreign firms were each granted a maximum of only 0.07% of the total offering. Recently, foreign firms were allocated a slightly larger share of the 24 percent securities share -- but the total was still equal to just 5.73 percent of the total offering.

The Japanese government has proposed new offerings of 6 and 15 years, but U.S. firms do not consider these issuances to be as attractive as the 10-year note.

U.S. firms are urging the Japanese government to adopt an

open auction system allowing full participation of foreign firms in government securities trading. The top executives of the four largest securities firms in Japan indicated a willingness to participate in an open auction system, but so far the proposal has met stiff opposition from the Finance Ministry, particularly within the Banking Bureau, which is reluctant to relinquish the banking syndicate's dominant position in this field.

While some progress has been made in this field, the members of the delegation agreed that the progress is inadequate and the pace of change far too slow.

Opening equal access to foreign firms in this area is addressed in the Schumer Amendment, adopted as part of the Omnibus Trade Bill (H.R. 3) by the House Banking Committee. The measure would rescind the New York Federal Reserve Board's granting of "primary dealer" status to two Japanese Securities firms (Nomura and Daiwa) because Japan does not allow similar access by U.S. firms to Japanese markets. The Schumer Amendment does not target Japan directly and would apply to any nation with closed markets.

2. Membership on Tokyo Stock Exchange. Despite the fact that the Tokyo Stock Exchange is now the largest in the world, it was only in 1986 that the exchange was open to membership by foreign firms. (Morgan Stanley, Goldman Sachs, Merrill Lynch and a British subsidiary of Citibank now have seats.) The TSE board has argued that physical limitations of 15 square feet per member prohibited further expansion at this time. The TSE is currently constructing new facilities and has indicated that some additional seats may be open to foreign firms.

U.S. firms argue that foreign firms should be given full access to the TSE if conformance to basic criteria set in advance can be met. They disdain the argument of physical limitations and point out that any qualified Japanese firm who pays the membership fee can hold a seat on the New York or London exchanges. British government officials have made similar pleas on behalf of British securities firms seeking to trade at the TSE.

At the conclusion of numerous meetings on the issue of TSE membership, exchange officials indicated that 2 to 14 new seats for foreign firms could be available as early as May, 1988, and that U.S. firms could anticipate receiving at least two additional seats. Members of the delegation believe that these expansion plans remain inadequate and that additional progress is urgently required.

3. Access to Foreign Exchange Markets. All foreign exchange transactions in Japan are limited to licensed foreign exchange dealers. Currently, all licenses in Japan are held by banks: Even though U.S. securities firms are experienced in foreign exchange transactions in the U.S. and other countries, Japanese banking interests have resisted efforts to open this field for even Japanese securities dealers.

U.S. firms are urging the Japanese government to allow U.S. securities companies to engage in foreign transactions, even if Japanese firms are not allowed into this area. They argue that a strong record of expertise in foreign exchange abroad entitles them to this access and point out that Japanese securities firms are currently allowed to conduct foreign exchange transactions in the U.S.

4. Access to Corporate Underwriting in the Domestic Equity Market. Currently, U.S. securities firms enjoy virtually no access to the underwriting of corporate ventures, despite their expertise in this area (U.S. firms now participate in approximately 1.5 % of new corporate underwriting.) Japanese firms with considerably less expertise have consistently more access to this area.

U.S. firms are urging the government and businesses to allow U.S. firms to participate on an "open market" basis, as Japanese firms are allowed to do in the U.S.

Issues in the Banking Industry

Only recently have U.S. banks sought a significant expansion of their activities in Japan. Simultaneously, Japanese banks are playing an increasingly larger role in the banking industry in this country. The perception of most American companies seeking to do business in Japan is that while the Japanese banks have been granted the same access to U.S. markets that U.S. banks themselves enjoy, significant barriers remain in Japan for all foreign banks. These barriers are most significant in these four areas:

1. Open Competition in the Japanese Government Bond Market. Japanese banks are consistently given enormous preference in their ability to purchase Japanese Development Bonds issued by the government. Currently, banks receive approximately 76 percent of each bond offering (securities firms receive the remaining 24 percent), but foreign banks have traditionally received less than 5 percent of the total banking share allocated.

U.S. banks are urging the government of Japan to adopt an open auction system where there are no quota or allocation systems restricting the portion of government bond issues each bank may receive. Japanese banks in the U.S. currently have unrestricted access in a fully open auction system for all U.S. government bond offerings.

2. Disparity in Capital Ratio Requirements for Japanese Banks. The Japanese government imposes a different and far less restrictive requirement on capitalization for Japanese banks than the U.S. Federal Reserve Board imposes on U.S. banks. (British banks also operate, by U.S.-U.K. agreement, under similar requirements to U.S. banks.) This allows the Japanese banks to operate under much less stringent capitalization requirements than do U.S. banks when doing business in Japan and the U.S.

U.S. banks are urging the Federal Reserve Board to impose uniform capitalization requirements on all banks -- U.S. and foreign -- doing business in the U.S. Simultaneously, U.S. banks are urging Japanese officials to adopt more stringent capitalization requirements on Japanese banks operating at home. Without such a uniform standard, U.S. banks could stand to lose billions of dollars in business to Japanese firms.

3. Access to Automatic Teller Machines by Foreign Banks. Currently, some 70 percent of all bank transactions in Japan are conducted through an extensive network of ATM's in Japan. At least one U.S. bank -- Citicorp -- has sought access to the ATM network operated by several Japanese banks. Although the banks agreed to an access arrangement, final approval of the U.S. access to this system was blocked by officials in the Ministry of Finance.

U.S. banks are urging the Japanese government to allow access on a negotiated basis to Japanese banks' ATM systems. Without this, U.S. banks contend they will be severely restricted from competing for any significant share of the Japanese consumer banking market.

4. Purchase of Japanese Banks by Foreign Banks. Because of the comparatively small number of Japanese banks (170) by U.S. standards, and because of a strong tradition of stability during the post-war period, there has been an extremely small number of ownership transfers of Japanese banks. However, of the small number occurring during the last few years, none have been acquired by U.S or other foreign firms. U.S. banks contend that Japanese banks and government officials have taken moves to preclude the possibility that a foreign bank could purchase a Japanese bank under any circumstances.

U.S. banks are urging the Japanese government to allow U.S. firms to openly and fairly compete for any Japanese bank which may be available for sale. During the past few years, the Japanese banks have been allowed to make several major purchases of U.S. banks in California and elsewhere.

As we continue to discuss and examine important issues in the area of trade in international services, I am certain that these points of difference will be highlighted. I hope you will feel free to contact me to discuss specific matters outlined here and I look forward to receiving any thoughts you may have.

Sincerely,

Charles C. Schumer

Charles E. Schumer
Member of Congress

CES:jwd

JAPANESE CHANGES NEEDED TO OPEN DOORS

Senator GRASSLEY. I have a question of Mr. Binney. I do not have a question of you, Congressman Schumer, but you may stay if you want to.

I have one question of Mr. Binney, and then two or three to submit for your response in writing, because of the time, and the necessity of me going to the Judiciary Committee.

But this is somewhat a summation of some points I think you made in your paper, but I think I would like to have them as it would deal directly with loan business, and what many bankers are telling us, the difficulties they have in that area. In fact becoming more and more difficult.

We have heard a number of the reasons mentioned, and they would include the Japanese access to the captive deposit base, and that of course would be aided by the tax system.

The fact of poorly developed short-term money markets. The fact of forced use to brokerage companies in raising funds. So my question is asking you to tell us the kind of changes that need to be made in Japan so that our banks are more able to compete effectively for this loan business.

Mr. BINNEY. Well, it is my judgment that the lending business, not just in Japan, but also in the world's major OECD countries is a contracting business. This is not unique to Japan. Spreads have come down because of competition.

We are finding, in Japan, that most of the creditworthy companies do not need loans. They are long-cash rather than short-cash. You do not lend money to Toyota; you borrow money from Toyota, or Matsusta, or others.

Therefore, the opportunities for lending are somewhat slimmer, and we, and others, are finding our loan volumes going down quite dramatically.

This is also being driven by return on asset considerations which are obviously somewhat larger for U.S. banks than they are for Japanese banks because shareholders in the stock market take more notice of ROA considerations than they do in Japan.

SECURITIES LICENSES ONE ANSWER TO PROBLEM

What is happening, though, is the securitization of debt. We are seeing debt, now, bundled up in pieces of paper that can be sold off, whether it be asset-backed, or some other mortgage pass-through facility, or generally, some unsecured obligation which is being floated on capital markets, whether they be domestic capital markets in Japan, or international capital markets in London, or elsewhere. And that is why the securities licenses that we now have, and that other major New York banks are about to receive, is, I believe, one of the answers to this problem. Because once we have a securities license we can than compete directly, not just with the Goldman Sachs, or Merrill Lynches of this world, but also with the Nomuras and the Daiwas of this world, in getting into the securitization process directly, which is the way that the lending business is going in the late 20th century around the world, in my judgment.

Senator GRASSLEY. And so you see that as long-term trend, so that any immediate changes in banking relationships are not even going to be helpful in the long-term?

Mr. BINNEY. They are not going to be helpful in terms of generating more loans, if that is what you are after. They are going to be helpful in terms of generating more foreign exchange business, or more trade business, or for me to be able to sell more service products of one sort, or another, or generally do more investment banking business, securities type business, trust banking business, pension fund management business, investment management business, and so on.

So if you broadly define commercial banking to include all those businesses, yes, it will be helpful, sir, but if you are just talking about the lending business, I think it is dying business in many countries around the world, including Japan.

Senator GRASSELY. I have no further questions. We thank you, as a committee, and myself, very much for your participation, and lending to the record by which we have to make some economic decisions for our budget consideration.

I want to say that the record will probably be left open for a few days—I think that is the tradition in this committee—so if there are any corrections, or additions you need to make, submit them to the staff.

Thank you very much. Meeting adjourned.

[Whereupon, at 10:50 a.m., the committee was adjourned, subject to the call of the Chair.]

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